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SAFEGUARDING AMERICA'S RETIREMENT SECURITY: AN EXAMINATION OF DEFINED BENEFIT PENSION PLANS AND THE PENSION BENEFIT GUARANTY CORPORATION

HEARING

BEFORE THE

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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CONTENTS

	Page
Opening statements:	
Senator Fitzgerald	1
Senator Akaka	4

WITNESSES

MONDAY, SEPTEMBER 15, 2003

Malcolm Wicks, Minister for Pensions, British Government	6
Peter R. Fisher, Under Secretary for Domestic Finance, U.S. Department of the Treasury	8
Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation	9
Christopher W. O'Flinn, Vice President, Corporate Human Resources, AT&T, on behalf of the ERISA Industry Committee	23
Kathy Anne Cissna, Director of Retirement Plans, R.J. Reynolds, on behalf of the American Benefits Council	24
Norman P. Stein, Law Professor, University of Alabama, on behalf of the Pension Rights Center	26
JoOhn P. Parks, Vice President, Pension Practice Council, American Academy of Actuaries	28
J. Mark Iwry, Senior Fellow, The Brookings Institution	30

ALPHABETICAL LIST OF WITNESSES

Cissna, Kathy Anne:	
Testimony	24
Prepared statement	98
Fisher, Peter R.:	
Testimony	8
Prepared statement	43
Iwry, J. Mark:	
Testimony	30
Prepared statement	142
Kandarian, Steven A.:	
Testimony	9
Prepared statement with attachments	54
O'Flinn, Christopher W.:	
Testimony	23
Prepared statement with attachments	72
Parks, John P.:	
Testimony	28
Prepared statement with attachments	125
Stein, Norman P.:	
Testimony	26
Prepared statement	116
Wicks, Malcolm:	
Testimony	6

APPENDIX

Charts submitted for the Record by Senator Fitzgerald	
Total Underfunding, Insured Single-Employer Plans	157
PBGC Net Position, Single-Employer Program, FY 1980–FY 2002	158
Uncertain Futures	159
Single-Employer Premium Income, FY 1992–FY 2002	160

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MONDAY, SEPTEMBER 15, 2003

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:31 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senators Fitzgerald and Akaka.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. Good afternoon. The Subcommittee will come to order.

Today, we are conducting an oversight hearing on the challenges facing the Nation's defined benefit pension plans. Broadly speaking, we will examine, one, the financial condition of the Pension Benefit Guaranty Corporation, the PBGC, the government-sponsored corporation which insures defined benefit pension plans; two, how Congress can help shore up the PBGC; and three, how Congress and the administration can help improve the accuracy of the actuarial and funding practices of company-sponsored plans and thereby help bolster the retirement security of millions of American workers.

The Nation's private sector defined benefit pension system is breaking down and needs to be fixed. Financially weak companies have for years made pension promises that they could not deliver and then simply dumped their unfunded pension promises off onto the PBGC. The PBGC is now being crushed by the weight of those claims.

Financially strong companies with responsibly managed defined benefit pension plans should be concerned because they may be unfairly forced to pay for the irresponsible promises of the financially weak and irresponsible companies. And taxpayers should be concerned, as well. If current trends continue, the taxpayers themselves may someday be called upon to pay for the pension promises of the irresponsible and financially weak companies that dump their pension plans on the PBGC.

If the current situation seems reminiscent of the savings and loan crisis of the late 1980's, that is because it is. And just as weak S&Ls then sent hoards of lobbyists to Washington asking Congress to prevent a day of reckoning, so, too, we now have companies with weak and underfunded pension plans flooding Congress with pleas for further indulgences. Let us hope that this time around, Congress doesn't succumb to the siren song of those who would urge us to roll the problem over into future years.

The reason we are here now is because the problem has been rolled over repeatedly in the past on the promise that things will get better tomorrow. Well, in my judgment, tomorrow is here, and we ought to act before it is too late.

Although pension fund assets totaled $1.6 trillion at the end of 2002, estimates indicate that private sector defined benefit pension plans are now collectively underfunded by nearly $400 billion. As illustrated in our first chart at the end of the dais, the level of underfunding has increased sharply in the last 2 years.[1]

The steel industry has already staked its claim against the PBGC, taking the top three spots for the largest claims submitted to the pension insurer in the last 2 years. Bethlehem Steel, whose pension plan terminated in 2003, had $3.9 billion in claims. LTV's pension plan terminated in 2002, with $1.9 billion in claims. And National Steel filed claims of $1.3 billion in 2003.

In its last filing prior to termination, Bethlehem Steel reported that its pension plan was 84 percent funded on a so-called current liability basis. The trouble is, if a plan terminates, the legislative definition of current liability is typically a figure that is far less than the actual amount of money that is needed to pay the benefits that are owed. Thus, it turns out that Bethlehem Steel's pension plan, which was 84 percent funded on a so-called current liability basis, was actually only 45 percent funded on a termination basis. As a result, the other companies that remain in the PBGC insurance program, or perhaps even someday the taxpayers themselves, will have to pay over 50 percent of the benefits which Bethlehem Steel promised its workers but apparently never funded.

It is here worth noting that despite its remarkably low level of funding, the laws currently on the books allowed Bethlehem Steel to make no cash contributions whatever in the 3 years prior to its plan's termination.

The PBGC's financial health has deteriorated dramatically in recent months, and I would like to refer you to the second chart.[2] The PBGC has experienced a swing from a $7.7 billion accumulated surplus at the end of fiscal year 2001 to a $5.7 billion deficit as of July 31, 2003. This swing amounts to a $13.4 billion swing within 22 months. The PBGC now faces its largest deficit ever, with the likelihood of additional severe losses in the immediate and intermediate future.

PBGC's record losses are primarily attributable to the recent termination of several severely underfunded pension plans sponsored by financially troubled and bankrupt companies. The combination

[1] Chart entitled "Total Underfunding, Insured Single-Employer Plans" appears in the Appendix on page 157.

[2] Chart entitled "PBGC Net Position, Single-Employer Program, FY 1980–FY 2002" appears in the Appendix on page 158.

of a decline in equity valuations and near record low interest rates has resulted in a double whammy for defined benefit pension plans.

Now, I would like to refer you to the third chart.[1] This is a chart that was copied with permission from the *Wall Street Journal.* As it illustrates, the unfunded pension liabilities of financially weak companies have soared in recent years. The PBGC currently estimates that when it closes out its fiscal year for 2003, the financially weak companies will have underfunded their liabilities by $80 billion. This figure is up $45 billion from last year's estimate.

Further complicating the financial stability of the PBGC is a steady decline of premium income. And for this, you can refer to the fourth chart.[2] It shows premium income declining from $1.1 billion in 1996 to just $787 million in 2002. This leveling off in 2002 results from more underfunded plans qualifying for exemption from paying the variable rate premium and an increasing number of plans being terminated. Premium income in 2002 at $787 million was substantially less than it was 10 years ago, in 1993, when it was $890 million. With a shift to more defined contribution plans, such as 401(k)s, it is unlikely that premiums will increase significantly in the foreseeable future.

At the same time that the PBGC's premium income has been falling, the benefits that the PBGC has become obligated to pay have been skyrocketing. Benefits paid in 1993 were $720 million. Last year, they were $1.5 billion, and this year, the benefits paid are likely to reach $2.5 billion, over three times the benefits paid in 1993 and many times the amount that the PBGC is taking in in premium income.

Obviously and quite simply, the long-term survival and success of the PBGC will be in jeopardy if the PBGC's premium income continues to decline and its benefit payments continue to rise at such a rapid rate. In my judgment, Congress must act quickly to force companies which sponsor defined benefit pension plans to do a better job of funding them, to stem the tide of terminations by financially weak companies, and to figure out a way to increase the PBGC's premium income, probably by converting to a more sufficiently risk-based system.

The plight of the PBGC is of great consequence to our Nation. The PBGC's two insurance programs, the single-employer insurance program and the multi-employer program, insure the pension benefits of over 44 million participants in more than 32,000 private defined benefit pension plans. As many as 1.8 million of those participants are in my home State of Illinois.

In July of this year, the U.S. General Accounting Office designated the PBGC single-employer pension insurance program as "high risk." This action is of particular significance because it marks only the third time in the history of the GAO's high-risk list that an agency or program has been added independently of the GAO's biennial report.

We cannot lose track among the acronyms and dollar figures of the toll this issue might have on working people across America. It is cruel and unacceptable to pull the rug from under hard-work-

[1] Chart entitled "Uncertain Futures" appears in the Appendix on page 159.

[2] Chart entitled "Single-Employer Premium Income, FY 1992–FY 2002" appears in the Appendix on page 160.

ing Americans by telling them some of their deserved and promised pension benefits no longer exist. It is also unacceptable to force the taxpayers to bail out the PBGC.

These principles should be our ground zero commitment to American workers, that government has an obligation to make companies live up to the promises they make to their workers and that it has an obligation to protect taxpayers from picking up the tab of a failed system.

United Airlines, headquartered in my State, which on a termination basis has underfunded its pension plan by some $7.5 billion, has recently been pushing for legislation that would allow it to receive a 5-year moratorium on deficit reduction contributions and then have 20 years thereafter to amortize the additional unfunded liability accruing during that time. The big risk, of course, is that United's pension plan would become even more unfunded and would eventually be terminated. The PBGC would then be stuck with hefty liabilities, United workers would lose benefits, and other companies would be forced to pay for one industry's unfunded promises.

Special interest legislation such as that proposed by United is exactly the sort which, in my judgment, will make the problem worse. As one of our distinguished witnesses said earlier this year, when you are in the hole, the first rule is to stop digging. I plan to do what I can to make sure that Washington does no more digging.

Clearly, changes are needed in the defined benefit pension system. In July, the administration proposed changes to improve the accuracy and transparency of pension information. The administration proposal focuses on three key areas: Improving the accuracy of plan sponsors' liability calculations, increasing the transparency of pension plan information, and strengthening pension funding to protect workers and retirees. We look forward to hearing more about this proposal from our witnesses.

In addition, this hearing will explore a number of issues and challenges facing the Nation's pension system and the PBGC. These include replacement of the 30-year Treasury bond rate; strengthening of funding rules; accurate measurement of assets and liabilities; current liability versus termination liability, the definition of those terms; declining PBGC premium revenue; increasing the extent to which pension contributions are tax deductible—they are only deductible now, as I understand it, up to the amount of your required contributions and it is difficult to make excess contributions in years that the company is doing well; the allowance of so-called alternative investments that some companies have been allowed to make; and another hot topic, the effect of cash balance plans.

We look forward to hearing the views of our witnesses on these and other issues affecting the Nation's pension system as well as their recommendations on ways to ensure the financial stability of the PBGC and the pension plans of companies the PBGC insures. At stake is nothing less than the financial security of millions of Americans who rely or are planning to rely on their company funded pension plans in their retirement years.

Now, before turning to our witnesses for testimony, I want to introduce the Ranking Democrat. Senator Akaka has arrived, and I

thank Senator Akaka for being here. Would you like to make an opening statement.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Yes, Mr. Chairman. I want to say good afternoon to you and our panelists. I want to thank you, Mr. Chairman, for holding this hearing today and, again, thank our witnesses for sharing their insights with us this afternoon.

Although more employers offer defined contribution plans such as a 401(k) plan than defined benefit plans, we must ensure that the Pension Benefit Guaranty Corporation is able to protect the retirement security of the estimated 34 million hard-working Americans participating in single-employer defined benefit pension plans. I am concerned that the PBGC lacks sufficient reserves to carry out its statutory responsibility of providing workers with protection when their former employers are no longer able to support their retirement benefits.

Comptroller General David Walker recently testified before the House Committee on Education and the Workforce about the risks that PBGC is and will be facing. He noted that in fiscal year 2002, PBGC's termination of defined benefit plans offered by Anchor Glass, Bethlehem Steel, and Polaroid accounted for a $4.2 billion loss to PBGC. While these plans represent the largest losses to PBGC in their respective industries, they are just three examples. In its latest review, GAO found that many of the single employer defined benefit plans are severely underfunded, which led Congress' non-partisan auditor to place the PBGC on its high-risk list in July.

The PBGC has faced deficit situations before. The agency was on the high-risk list in 1990, due to weak funding rules and ran deficits during the mid-1980's and early 1990's. Congress enacted legislation to strengthen minimum funding standards and to enhance rules on variable rate premiums paid by defined benefit pension plans.

Although the PBGC has faced problems before, to which Congress responded, it is critical that we act once again to ensure that PBGC is self-supporting. Most PBGC revenue comes from premiums set by Congress and paid by the private sector employers that sponsor defined benefit plans. Other sources of income are assets from terminated plans taken over by the PBGC, investment income, and recoveries collected from companies when they end underfunded pension plans.

To shore up the financial foundations of PBGC, there must be greater transparency of plan information so that workers understand the stability of their plans and the contributions that are made by their employers. Employees should know if the company for which they work will be unable to pay employee pensions.

There are those who believe we should adopt limited, short-term changes to pension funding rules and just wait out the current economic conditions that pose risks to the PBGC. Others recommend measures to address loopholes in funding rules. The administration has proposed changing the rate at which an employee's contribution is calculated over the long term. It is crucial that we work together to secure the retirement security of American workers.

I look forward to discussing what can be done to guarantee that companies honor their pension commitments, and when these promises cannot be met, what must be done to make sure that the PBGC is sufficiently funded to carry out its statutory mission as insurer of the private defined benefit pension plans.

We look forward to the hearing and the testimony, Mr. Chairman, and I thank you for holding this hearing.

Senator FITZGERALD. Thank you, Senator Akaka.

I am pleased to tell you that we have a special guest here from the Nation of Great Britain, our great friend and ally, Malcolm Wicks, who is the Pension Minister in British Prime Minister Tony Blair's cabinet. Mr. Wicks was appointed in 2001 as the Parliamentary Under Secretary of State for Work at the Department for Work and Pensions. Mr. Wicks has had a distinguished career of service to the British Government, also having served as Parliamentary Under Secretary of State for Lifelong Learning at the Department for Education and Employment, and as Chairman of the Education Select Committee, and as a Member of Parliament.

Mr. Wicks, we are delighted to have you here. I understand that you are working on some new legislation in Great Britain and I would like to give you the opportunity to address the panel for as long as you would like to go on. Thank you very much for being here.

TESTIMONY OF MALCOLM WICKS, MINISTER FOR PENSIONS, BRITISH GOVERNMENT

Mr. WICKS. Mr. Chairman, may I first of all thank you, and indeed Senator Akaka, for this opportunity to say a few words. I promise to detain the Subcommittee only a few minutes, because knowing the Subcommittee system in my own country, you have important work to do and important witnesses. But I thank you for your kindness and courtesy in giving me this opportunity, which as both a Parliamentarian myself and as a Minister, I genuinely regard as a very great privilege.

May I say that the close relationship between Great Britain and the United States extends to social policy, and I think we are increasingly learning a great deal from one another. We are here on a relatively short visit to Washington, essentially to listen and learn.

The United Kingdom, like your country, finds itself in a situation where pensions as increasingly rising up the agendas that count, particularly the agenda of public opinion. Our demographics are not dissimilar. I am struck by the fact that whereas 100 or so years ago, many working Americans, and certainly many working Britains, never outlived their working life. Today, there is the concept of retirement and, indeed, in the 21st Century in the United States and Great Britain, many of our citizens may have retirements lasting 20, or indeed, increasingly 30 or more years. So this couldn't be more important as an issue.

I do not believe that we face crisis. I think we overuse the term "crisis." We should use it properly and in context. But we all face in our democracies very formidable challenges.

Like in the United States, in the United Kingdom, there is concern about occupational pensions, defined benefit or final salary

schemes, and we plan to legislate in our coming session in the House of Commons to introduce what we will call pension protection funds, drawing very much on the experience of the Pension Benefit Guaranty Corporation. And may I say that we have had useful meetings in Washington over the last few days, not the least with Steven Kandarian and his colleagues this morning. I am grateful to him and, indeed, the cooperation they are giving to our officials who are asking some very detailed and searching questions about the Corporation's operation.

Senators I am very grateful for this opportunity and thank you very much.

Senator FITZGERALD. Minister, thank you very much for being here. We thank you for joining us today, and good luck on setting up your form of the PBGC. Thank you very much.

At this time, I would like to welcome our first panel with two distinguished witnesses. Our first witness is the Hon. Peter R. Fisher, the Under Secretary for Domestic Finance of the U.S. Department of the Treasury. Secretary Fisher was sworn in on August 9, 2001. His experience and understanding of the financial markets proved invaluable as our Nation and our financial system responded to the terrorist attacks of September 11.

Secretary Fisher's accomplishments include his leadership in helping to improve and streamline our government's fiscal practices and policies, enacting terrorism risk insurance, promoting job creation and investment, developing policies on deposit insurance reform, advocating for enhanced disclosure by government-sponsored enterprises, working to prevent identity theft, and improving Federal debt management practices.

Under Secretary Fisher will be departing the Department of Treasury in the next month. In my judgment, his departure will be a great loss for the entire Federal Government.

I would also like to welcome Steven A. Kandarian, who is the Executive Director of the Pension Benefit Guaranty Corporation. Prior to joining the PBGC, Mr. Kandarian was managing director and founder of Orion Partners, L.L.C., in Boston, Massachusetts, where he managed a private equity fund specializing in venture capital and corporate acquisitions. He also was managing director of Lee Capital Holdings, a private equity firm also based in Boston, and was an investment banker in Houston, where he specialized in mergers and acquisitions and initial public offerings.

The government is especially grateful to have an individual with such extensive private sector financial experience at the helm of the PBGC during this difficult time. His grasp of the issues surrounding the pension system and the PBGC, as well as his innovative ideas, are a significant and timely addition to the public policy debate underway.

Again, I want to thank you both for being here and I would tell Minister Wicks, it won't be rude if you get up. You don't have to wait through the whole hearing, and you can stay as long as you like, but we will not feel hurt if you have other commitments, so thank you.

Under Secretary Fisher.

TESTIMONY OF PETER R. FISHER,[1] UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Mr. Chairman, and thank you for those generous and kind introductory remarks. Mr. Chairman, Ranking Member Akaka, I am very pleased to be here with Steve Kandarian to discuss our defined benefit pension system. Mr. Kandarian will discuss the current financial condition of the PBGC and I would like to discuss the administration's proposals for strengthening the long-term health of our defined benefit pensions.

Pension plan underfunding and the PBGC's deficit are symptoms of a serious structural problem in the defined benefit pension system. As you noted, Mr. Chairman, the GAO reached the same conclusion in placing the PBGC's single employer insurance program on its list of high-risk government programs. The time to fix the system is now, while the problems are still manageable.

In our view, the best way to protect the PBGC is to be sure that pension plans are adequately funded. This is also the best way to provide pension security for our Nation's workers and retirees.

Pension problems can be placed into two priority categories, comprehensive reform issues that need our prompt attention and more narrowly-focused issues that need Congress' immediate attention.

Comprehensive reform issues include strengthening pension funding rules, reexamining and updating certain key actuarial assumptions, and shoring up the PBGC's insurance program overall. My written testimony, which I ask to be included in the record, outlines the full range of issues the Congress and the administration will need to address to achieve comprehensive reform. Let me now just summarize the three areas where we have asked Congress for immediate action.

First, accurate measurement of pension liabilities. Fixing the pension funding rules won't help unless we ensure that we are accurately measuring the pension liabilities on which those rules rely. Our first step is replacing the 30-year Treasury rate required under current law to be used as a discount rate in measuring pension liabilities for minimum funding purposes.

The administration recommends that pension liabilities ultimately be discounted with rates drawn from a corporate bond yield curve that takes into account the term structure of pension plans' liabilities. For the first 2 years, pension liabilities would be discounted using a blend of corporate rates. A phase-in to the appropriate yield curve discount rate would begin in the third year and would be fully applicable by the fifth year. Using the yield curve is essential to match the timing of future benefit payments with the resources necessary to make those payments. Our proposal is consistent with well established best practice in financial accounting, can be readily implemented by plan sponsors, and provides a transition period for implementation.

Second, we think we need greater transparency of pension funding. There is no requirement under current law that workers and retirees covered by defined benefit pension plans receive regular, timely information on their plan's financial condition. We propose to remedy this by requiring that each year, sponsors provide each

[1] The prepared statement of Mr. Fisher appears in the Appendix on page 43.

participant with the value of his or her pension plan's assets and the level of liabilities measured on both a current liability and a termination basis. Not only will disclosure of this information be valuable for those covered by plans, it will provide a powerful incentive for sponsors to keep their plans well funded.

Third, containing the risks to the PBGC of underfunded plans. Underfunded plans sponsored by financially weak firms which pose the greatest risk to the PBGC have few restrictions in expanding benefits. The administration proposes to add some protection for the PBGC by strengthening the restrictions on those plans in making new promises.

In summary, Mr. Chairman, we face a real problem today. We need to act this year in these three areas that I have identified and then we will have provided the basis for which to move on to comprehensive reform. The administration stands ready to work with this Subcommittee and the rest of Congress to accomplish these goals. Thank you very much.

Senator FITZGERALD. Thank you, Mr. Secretary.

Mr. Kandarian, you may proceed with your opening statement.

TESTIMONY OF STEVEN A. KANDARIAN,[1] EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Mr. KANDARIAN. Mr. Chairman, Ranking Member Akaka, thank you for holding this hearing on pension funding and the financial health of PBGC.

Defined benefit pension plans continue to be important for the retirement security of millions of Americans, but recently, there has been a sharp deterioration in plan funding.

In July, the administration proposed improving the way pension liabilities are calculated, increasing the transparency of pension funding, and providing new safeguards against underfunding by financially troubled companies. The administration also called for funding reforms.

In addition to urging the Subcommittee to act upon these important measures, my testimony today will focus on PBGC's financial condition, plan underfunding, and some of the challenges facing the defined benefit system.

During fiscal year 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion, a loss of $11.3 billion in just 1 year. Based on our latest unaudited financial report, the deficit has grown to $5.7 billion as of July 31, 2003.

As you just mentioned, GAO recently placed PBGC's single-employer insurance program on its high-risk list. My hope is that GAO's high-risk designation will spur reforms to better protect the retirement security of American workers.

As of December 31, 2000, total underfunding in the single-employer plans was less than $50 billion. Because of declining interest rates and equity values, as of December 31, 2002, 2 years later, underfunding exceeded $400 billion, the largest number ever recorded. Even with the recent rises in the stock market and interest

[1] The prepared statement of Mr. Kandarian with attachments appears in the Appendix on page 54.

rates, PBGC projects that underfunding still exceeds $350 billion today.

Because large plans typically invest more than 60 percent of their assets in equities, there is a mismatch between pension assets and pension liabilities, which tend to be bond-like in nature. With the market conditions of the last 3 years, this asset-liability mismatch caused many plans to become significantly underfunded.

In addition to massive underfunding and vulnerability to equity market volatility, the defined benefit system faces other serious challenges, including adverse demographic trends and weaknesses in the pension funding rules. While each of these challenges is discussed in my written testimony, given time constraints, I will focus on four key weaknesses in the funding rules.

First, the funding targets are set too low. Employers can stop making contributions when the plan is funded at 90 percent of current liability, a measure that reflects past legislative compromises, not the amount of money needed to pay all benefits if a plan terminates. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants.

Second, the funding rules often allow contribution holidays. Even seriously underfunded plans may not be required to make annual contributions. Bethlehem Steel, for example, made no cash contributions to its plan for 3 years prior to plan termination, and the U.S. Airway pilots' plan had no cash contributions for 4 years before the plan was terminated.

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

Fourth, because of the structure of the funding rules, contributions to plans can be extremely volatile. After years with little or no required contributions, companies can be faced with sharp spikes in funding. Although our complicated funding rules were designed in part to minimize the volatility of contributions, the current rules have failed to achieve this goal.

Mr. Chairman, we must make fundamental changes to the funding rules that will put underfunded plans on a predictable, steady path to better funding. The administration is working on comprehensive reforms that will get pension plans better funded and eliminate some of the risk shifting and moral hazard in the current system.

It is our hope that these reforms will put the defined benefit system on a stable footing for the long term. If companies do not fund the pension promises they make, someone else will have to pay, either workers in the form of reduced benefits, other companies in the form of higher premiums, or taxpayers in the form of a PBGC bailout. We should not pass off the cost of today's problems to future generations.

Thank you, Mr. Chairman, for inviting me to testify. I will be happy to answer any questions.

Senator FITZGERALD. Thank you both very much. We appreciate your being here and appreciate your good insights in your opening statements.

Mr. Kandarian, I would like to begin with you. You focus mainly on trying to shore up the funding of the plans themselves. You noted that the funding targets are probably too low. I do want to address that later on, but at the outset, I want to address the problem with your premium revenue being so low compared to the benefits you are paying out. Obviously, that is not sustainable.

You are getting less premium revenue now than you were 10 years ago and claims against you, or benefits that you have to pay out, have tripled, roughly, in the last 10 years. If I understand it, you are going to pay out about how much this year, $2.5 billion, is that correct?

Mr. KANDARIAN. Our current run rate, Mr. Chairman, is $2.5 billion. We anticipate in fiscal 2003 that number going up to perhaps $2.9 billion.

Senator FITZGERALD. In this fiscal year?

Mr. KANDARIAN. Fiscal 2003, beginning October 1. Oh-four, pardon me.

Senator FITZGERALD. OK. So going up to $2.9 billion next year?

Mr. KANDARIAN. Yes.

Senator FITZGERALD. And how much in premium income do you have?

Mr. KANDARIAN. We are taking in just under $800 million a year in the single-employer program currently.

Senator FITZGERALD. OK. So you are eating into your trust funds to pay these claims on an ongoing basis. Obviously, this isn't sustainable for the long term, barring some kind of incredible upturn perhaps in the equity funds that you hold, but those are only about 30 percent of your overall trust funds, isn't that correct?

Mr. KANDARIAN. Yes. Our equity investment allocation is approximately 30 percent today. What would have to happen for us to get back in balance would be a dramatic improvement in our equity returns, premium income that would continue at these levels or perhaps higher because the variable rate premium may kick in a little bit stronger, but we still do not anticipate under the current rules that that number would exceed $1 billion. It would be less than $1 billion a year.

Senator FITZGERALD. OK. So the question I have for you is are our insurance premiums sufficient? It doesn't look to me like they are anywhere close to being sufficient.

Mr. KANDARIAN. Well, the administration is looking at all these different avenues. We have no specific proposal at this point in time on premiums. But, really, the first thing I hope we can do is, in addition to studying the correct measure of these liabilities, is to get these plans better funded so that when they do come into this agency, that instead of coming in 50 percent funded, they come in 80 or 90 percent funded if there is a need for PBGC insurance.

Senator FITZGERALD. So it is more manageable if you have to take them over. What about funds that are leaving the PBGC? There is an increasing number of pension plans that are just leaving the fund. They are switching their workers over to defined con-

tribution plans. That is also having a negative effect on your premium income, correct?

Mr. KANDARIAN. Well, the premiums are determined based upon numbers of plan participants. That number has pretty well leveled off. So it is driven by that number as well as the variable rate premium amount.

So what really happened in the last few years was the variable rate premium was coming down, largely because of the way it is measured and because plans did get well funded in the late 1990's with the stock market boom. But those rules have a lag effect to them. The variable rate premium will start to increase, but again, we don't anticipate it going up above $1 billion, which at one point we did have in premiums.

Senator FITZGERALD. Now, I was struck by the figures that Bethlehem Steel, prior to its termination, claimed to be 84 percent funding in its last filing prior to termination——

Mr. KANDARIAN. Right.

Senator FITZGERALD [continuing]. On a so-called current liability basis, and current liability, it is a very complicated definition. I tried to unscramble it yesterday. I had several staff members working on it and we found why there is a whole industry of ERISA lawyers out there and why they are highly compensated. It is very convoluted. It is not a simple definition. I gather there are all sorts of different ways of calculating it.

But the bottom line is, whatever current liability is in ERISA, it seems to be something less than the actual amount of money you have to put in to pay off the claims. You found that Bethlehem Steel was 84 percent funded on a current liability basis, but on a termination basis, only 54 percent funded.

Mr. KANDARIAN. Yes, Senator. What occurred there was, as you mentioned, the definition of current liability is dramatically different, especially in the case as we had here recently with declining asset values and declining interest rates, which drove up stated liabilities. So the definition of current liability results in these much higher stated amounts of funding, and, in fact, for the 5 years before Bethlehem Steel came into our agency on a terminated basis, the company made no variable rate premium payments to us.

The variable rate premium is supposed to reflect these underfunded plans, and here was the largest underfunding the agency ever had taken on in its history by a factor of two and there was no variable rate premium paid to the agency for 5 years. In addition, over the last 5 years, only about $40 million of cash contributions went into this pension plan that was $4.3 billion underfunded when it finally came in. So the current liability measure can really be misleading when a company is in a death spiral and terminates its pension plan.

Senator FITZGERALD. Now, some of the later witnesses are going to criticize you for focusing on termination liability because they say that that is a number taken by calculating the cost of buying annuities from insurance companies when terminating a plan and that, in fact, you don't buy annuities. So why do you think termination liability is an important number?

Mr. KANDARIAN. Well, when a company terminates its pension plan, even if the company doesn't go out of business, they can do

what is called a standard termination simply to exit the system and start using some other vehicle, perhaps 401(k)s. They go to insurance market and they price out these liabilities in the marketplace and they basically defease these liabilities with insurance companies, and the question becomes, even for a company that is going out of business, if they had enough money in the pension plans, and occasionally one of several pension plans may have enough money in it to buy a standard termination annuity in the group annuity market, those obligations, those liabilities won't come to the agency under law. They will go right to the insurance market.

So it is really an apples-to-apples basis of what did these liabilities cost in the private marketplace, and for the government to say, we are going to price these liabilities higher or lower, I think would be wrong.

Senator FITZGERALD. Senator Akaka, you may have questions you want to ask at this point, and then I will ask some questions of Secretary Fisher.

Senator AKAKA. Thank you very much, Mr. Chairman. I do have some questions.

If I may digress for just a moment, I would like to thank Mr. Fisher for bringing the challenges of the Postal Service to the attention of the administration. As the former Chairman of the Committee's Postal Subcommittee, I appreciate your interest and efforts in this area.

I also want to add my welcome to Minister Wicks for being here with us today.

Now, let me turn to the issue at hand—the need to protect workers' pensions insured by the PBGC. As the testimony of our panelists will show, there are diverse views and little consensus on how the complex issues of pension funding should be approached. I am concerned that the administration proposal could unfairly impact unionized workers.

The Department of Labor estimates that 69 percent of unionized workers have pension plans as compared to 14 percent of nonunion workers. The U.S. manufacturing industry is more likely to employ a unionized workforce because manufacturing jobs are more likely to be unionized and are more likely to offer pensions.

Mr. Fisher, do you believe that the administration's proposal would affect union employees' pension plans?

Mr. FISHER. Senator, first, let me be very clear. We certainly hope that it will affect their pension plans by getting them better funding.

The connection, as I see it, is that there are in heavy manufacturing a tradition of higher rates of unionization and of older workforces at this point, and we have already at this hearing discussed some of the problems in the steel industry. If we don't get to accurate measurement of pension liabilities, those very workers are the ones who will be most greatly at risk to have underfunded pension plans.

So we think it is of paramount importance to make sure that their retirement security is as protected as we can make it to get to accurate measure of liability and that motivated the administration's proposals we made in July.

Senator AKAKA. Thank you, Mr. Fisher.

Mr. Kandarian, in your testimony, you mentioned that PBGC is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. Furthermore, PBGC operates from premiums that it receives from program participants, and your testimony states that PBGC receives no Federal tax dollars.

My question to you today is, what incentives could keep employers' well-funded pensions with PBGC?

Mr. KANDARIAN. What incentives could keep companies in the defined benefit system? I think probably the best incentive is to get this system on a stable footing, and there are a number of ways to do that.

First, as Secretary Fisher has mentioned, having accurate measure of liabilities is very important. Disclosure is very important, and if I may digress to the question you asked Mr. Fisher a moment ago, it is important for union members to know the status of their pension plans. Are they well funded? Are they underfunded?

If all they hear are these current liability-type numbers that the Chairman mentioned, they may be misled into thinking that if a company is in trouble financially, that their plan is well funded and they won't lose any benefits, when, in fact, their plan may be highly underfunded if the plan terminates. Our disclosure proposals would enable workers to learn what the real numbers are. It would enable unions, in particular, to put pressure on companies potentially to make sure these plans are properly funded.

So I think the proposals the administration has talked about would be very beneficial to the system and many of the workers that you are referring to and you are concerned about.

Senator AKAKA. Mr. Kandarian, I have another question. Since PBGC does not receive any taxpayer dollars and is not backed by the Federal Government, how does the PBGC invest the premiums that it receives from employers and does this strategy need to be changed to address the additional benefit payments as a result of the recent terminations of large underfunded plans?

Mr. KANDARIAN. The narrow answer to your question is the premium dollars are all invested in U.S. Treasury securities, long-duration U.S. Treasury securities. Those are very safe, of course. They aren't necessarily the highest returning securities.

The broader question, I think, would be where are the other dollars we have invested, and those are from the trust funds, the plan assets that come in to us from a terminated pension plan, and those dollars since 1994 have been invested largely in the U.S. stock market. The PBGC Board is now considering current investment policies and we anticipate soon that there will be some feedback for the agency as to whether to retain the existing direction or to modify that direction in any way.

Senator AKAKA. Mr. Chairman, my time has expired. I have further questions.

Senator FITZGERALD. OK. Thank you.

Mr. Fisher, I want to give you an opportunity to describe the administration's proposal for having a yield curve that would be used in making the calculations regarding a plan's liabilities. Historically, we have used a 30-year Treasury rate, and since you had a

role in phasing out the 30-year Treasury bond, now we are looking for a new benchmark and corporate America would like to take advantage of corporate bond yields, but the administration has proposed that we apply a yield curve to more tightly estimate the liabilities a plan faces. Could you explain the administration's proposal in that regard?

Mr. FISHER. Certainly. Thank you, Mr. Chairman. The administration has agreed with a number of members of the pension community that moving to a corporate interest rate more closely tracks the quality of the promise. That is, a pension liability is like the liability of a company, so like a bond rating that a company issues, a pension promise is a promise made by a corporate sponsor. So at a conceptual level, we share that it would be appropriate to move from the U.S. Treasury yield curve, which reflects the full faith and credit of the United States, to a high-grade corporate credit.

However, in the interests of accuracy, we think that it is very important, indeed, incumbent on us, to reflect the time structure of the benefit promises that companies have made. Using a single interest rate really distorts, especially when you use a long-term interest rate, distorts the valuation of a series of promises or liabilities.

To use a very simple example, if I owe you $100 next year and I also owe you $100 10 years from now, if we use a single 10-year rate to value both of those in present value terms, we are going to significantly understate the value today of the burden I face in paying you that $100 next year.

Given the demographics in our country of an aging population, particularly in industries with defined benefit plans, we think it is especially important to reflect these payments that will be made over the coming years in coming to an accurate measure of the pension plan.

Now, it is really—mechanically, it is a very simple two-step process. Plan actuaries come up with estimates, and this is the difficult part, the estimates of how many dollars have to be paid out in each year, and they have to do that no matter what interest rate is used. Once they come up with those estimates of how many dollars are paid in 1, 2, 3, 4, or 5 years, they then have to apply an interest rate to discount those to present values.

Well, at that step in the operation, you can apply the same interest rate to all of the different annual payments and come up with what we know will be an inaccurate measure, or you can apply the correct interest rate, a 1-year rate for the 1-year flow, a 5-year rate for the 5-year flow, and come up with the most accurate measure of liabilities that we know of. This is standard practice now in banking and in financial markets. We think it is the right way for us to measure pension liabilities to be accurate. This may seem complicated for the layman, but for those whose job it is to value money sums across time, this is really standard industry practice today.

Senator FITZGERALD. Well, the goal here is just to make the judgment of the liabilities more accurate, isn't that correct?

Mr. FISHER. Absolutely, Senator.

Senator FITZGERALD. Why do you think anybody would oppose making those judgments more accurate?

Mr. FISHER. Well, an uncle taught me—I had an uncle who was a physicist—that habit is the most underestimated variable. And in this area of pension accounting, there is a habit of using a single interest rate for the last 30 years. It was embedded in statute in 1987. I think financial market practices have been evolving over the last 20 years and now it is time for these statutes to catch up.

Senator FITZGERALD. Isn't it true, though, that the Financial Accounting Standards Board is now referencing using different discount rates depending on the maturity of the obligation in the pension——

Mr. FISHER. I know they are in the process of reviewing their rules, and just as we have been reviewing the statutory framework, they have been reviewing the accounting framework. We all know this is the best practice that we need to be evolving toward.

Senator FITZGERALD. And, in fact, some actuaries presumably do this. I believe I read somewhere that there is something in the website of an actuarial association that refers to a way of matching the maturity of the obligations with the fund's assets. And so it is likely to become an increasing practice and you are just trying to make it more accurate.

Now, I think the critics who are going to testify after you, the one criticism that I suspect they will have of this plan, is that the market for corporate bonds, especially long-term corporate bonds, can be rather thin. So whatever yield curve is out there isn't all that solid. Obviously, we don't have as deep a corporate bond market as we do have in Treasuries. Do you have a response to that criticism?

And would you only be talking about AAA-rated companies or investment grade rated corporates? Obviously, they would probably like the highest discount rate they could get, so maybe they would even want the low investment grade corporates to be used as a benchmark, but that is not what you have in mind.

Mr. FISHER. No, Senator. First, let me be clear. If the legislation is enacted as the administration has proposed, we would imagine an extensive rulemaking process under the Administrative Procedures Act, fully transparent for all interested groups to comment and have an opportunity to look at all the details of the index that we would create. That is step one that I think is very important.

As I explained in my written testimony, toward the back of a rather extensive testimony, I will concede, we do think that a few adjustments will be necessary to deal with the problem that there may be spotty liquidity along the yield curve. We would not be adjusting for the level of rates. But we would look to the Treasury yield curve for the structure of interest rates, the shape of the yield curve, to make some adjustments, as is very common in the creation of fixed-income indices in our financial markets. I want to be very clear about that. That is not a—we would look to high-grade corporate bond, whether AAA or AA. We are not wedded to that, but that is the sort of issue we would like to be fleshing out through——

Senator FITZGERALD. Do you have the power to promulgate this rule now without Congress' authorization? You do have a lot of power under the current ERISA law, don't you, to reference——

Mr. FISHER. I don't believe that we would have the authority under current law to create a curve and have the curve be used in valuing the minimum funding requirements.

Senator FITZGERALD. OK. You have to have legislative help on this and replacing the 30-year Treasury rate. We are now using, is it 120 percent of the 30-year Treasury——

Mr. FISHER. Yes, that is——

Senator FITZGERALD [continuing]. Temporarily until December, and we have got to have legislation before the end of the year, and, in fact, the sooner the better so companies can plan for their liabilities next year.

Mr. FISHER. Absolutely, Senator.

Senator FITZGERALD. I have a couple of more questions for Mr. Kandarian. Right now, companies file a statement with you that shows their termination liability, but that is kept secret and it is not open to the public, not to stockholders of the company, and not to plan members, is that correct?

Mr. KANDARIAN. Currently, there is a Section 4010 filing that companies with more than $50 million in underfunding file with us. So a plan has to be, generally speaking, one of the larger plans and to be significantly underfunded and they file this form with us which we typically receive within 3½ months of the year end.

Senator FITZGERALD. I am trying to figure out how it came to the point that these filings are secret. Wouldn't it be in the public's interest, particularly if you are a worker at the company who is a participant in the pension plan, to know the termination liability of the company?

Mr. KANDARIAN. I think the way it came about in the last go around in the legislation was that companies were reluctant to have this information in the marketplace, and they gave reasons why, and that was the compromise at that point in time.

The administration, however, feels that at least some of this data should be made public so that shareholders and financial market analysts see this information, as well as workers and plan participants.

Senator FITZGERALD. So in certain cases, this could be bad news that is being kept from the public, whether from investors or from members of the pension plan.

Do you have any idea—I believe there were some articles last Friday, a *Reuter's* one I recall specifically, that discussed that United Airlines is considering terminating its plan and dumping its liabilities on the PBGC. My understanding is that the claim the PBGC filed in the bankruptcy court earlier this year was for a $7.5 billion claim for termination liability.

What would be the effect on the PBGC if a pension plan the size of United and as underfunded as United's plan were to be terminated and handed off to you?

Mr. KANDARIAN. Well, we don't today anticipate that all the pension plans of United would come to us in the near future, but there is no way for us to control that, obviously, and that will play out in the marketplace with United's efforts to emerge from Chapter 11. So we are hopeful that they can do that, but we don't have much control over that at our agency.

The $7.5 billion number was a contingent claims or placeholder that we put into the record in a bankruptcy proceeding should the plans terminate and come to us. But it wasn't our stating that we thought it was going to come to us.

In terms of what it would do to our financial situation, as we mentioned, we are currently $5.7 billion in deficit. You correctly note our claim is for—our contingent claim is for $7.5 billion. However, we don't guarantee 100 percent of benefits and we cap out benefits, especially for highly compensated individuals, which some people in the airlines would fit into. So I don't have an exact number for you today, but we would anticipate more than $5 billion would be the impact upon us should all those plans come to the agency. Again, we are not predicting that to be the case. I am simply trying to be responsive to your question.

Senator FITZGERALD. OK. I know the administration hasn't made a proposal in this regard, but it seems to me that the premiums should be more risk-based than they now are. Could you explain to me to what extent premiums for PBGC insurance are risk-based today? I analogize to banking, where they went to risk-based premiums a number of years ago after the S&L debacle.

Mr. KANDARIAN. Well, today there are, again, two elements to the premiums paid to PBGC under a single-employer program. One is a fixed rate, $19 per participant. There is no risk-based component to that. It is regardless of how risky a plan is to the agency.

The variable rate premium is nine-tenths of one percent of so-called underfunding, but it is defined, again, based upon this current liability-type measure, which as we know, is wanting oftentimes during situations of bankruptcy and termination. So there is very little truly risk-based aspects to the current——

Senator FITZGERALD. Isn't that kind of unfair to the—you do have many well-funded, responsibly managed plans in your fund, and isn't it unfair that they are paying the same premiums as some terribly underfunded pensions?

Mr. KANDARIAN. Well, certainly those who are paying the $19 and are overfunded and are AA or AAA credits, I imagine are paying more than what would be a typical private sector insurance rate for their plan in many cases.

Senator FITZGERALD. It strikes me—I know that you guys have received a lot of flack from some in the corporate world that you are being real tough on the pensions, but I am giving you ideas on how you could be a whole lot tougher, aren't I. Mr. Fisher.

Mr. FISHER. If I could, Senator, just to jump in here, to clear something——

Senator FITZGERALD. Maybe you could pull the microphone a little closer.

Mr. FISHER. Just to underscore a point I think Director Kandarian made a few minutes ago, there really are two ways to come at this. You are suggesting that premiums are too low given the level of risk. The other side of it, we would all rather see less risk in the system.

So one reason why the administration hasn't yet come forward with an issue on—recommendation on the premiums is to see how far can we go in reforming the measurement and the funding rules and then come back and look at the balance of how much risk is

in the system, what should the premium structure be. But we fully take your point and we believe that a thorough review of the premium structure should be part of any comprehensive reform.

Senator FITZGERALD. So the passage of your plan, if it helps to shore up the funding of the pension plans that are out there, could ultimately save the members in the PBGC from having to endure a premium increase and could save them money.

Mr. KANDARIAN. I think that is right, yes. And I have testified several times before Congress in the last 2 years. I think in virtually all my testimonies, I have always started by saying our first choice is for the dollars to go into the plans to better fund the plans.

Senator FITZGERALD. Rather than just into premiums. Now, I have to ask a question about two things, Mr. Kandarian. What about non-standard assets? I understand that in some cases, you have allowed some companies to put stock that is not publicly traded, for example, into their pension plans in lieu of cash. When do you allow that, and is it an exemption to rules that allows you to allow alternative investments?

Mr. KANDARIAN. Let me start by saying those are Title I issues under ERISA, which is really the jurisdiction of the Department of Labor that is not here today. I don't want to speak for them, but I can give you some general guidelines and information on that.

Current law prohibits companies from putting in more than 10 percent of employer securities into their defined benefit pension plans in terms of assets. So we already have that safeguard.

In addition, there are securities that sometimes require exemptions to place into these pension plans, regardless of the 10 percent level, because they may not be tradable or one thing or another. And that is looked at on a case-by-case basis by the Department of Labor.

Senator FITZGERALD. In general, companies have to put cash or marketable securities into their plans?

Mr. KANDARIAN. Yes.

Senator FITZGERALD. Do you ever require plans to collateralize, in effect, their unfunded pension liabilities? Can you take security? Can you take a lien on any corporate assets as a means of enforcing the company's viability?

Mr. KANDARIAN. I am trying to think here, but the place where I recall seeing security use would be in the cases of waivers granted by the IRS. Oftentimes in granting the waiver, the IRS will require securities being put up in lieu of cash.

Senator FITZGERALD. But by and large, when a company files bankruptcy and terminates its plan, you don't have any security for the unfunded liability, by and large.

Mr. KANDARIAN. In bankruptcy, we are generally an unsecured creditor, that is correct. There are some exceptions to that, non-bankrupt subsidiaries. We have a stronger standing in bankruptcy as to non-bankrupt subsidiaries. We also have a stronger position in bankruptcy for missed minimum funding payments and for missed premiums to the agency. But generally speaking, that is a very small percentage of the exposure the agency faces. Typically, we get back less than 5 cents on the dollar in bankruptcy on the underfunded amount.

Senator FITZGERALD. My final question, and then I will turn it over to Senator Akaka if he has any more questions of this panel, would be for Secretary Fisher. My understanding is that during the 1990's, Congress closed some opportunities in the tax code that companies formerly had to put more than the required payments into their pension plans and to get a tax deduction for those payments, and apparently during the 1990's, we severely cut down the extent to which companies can get a tax deduction for contributions to their pension plans. And as a result, in the late 1990's when corporate America was generally doing very well, we didn't see any excess contributions to pension plans in the aggregate, and in fact, my understanding is there is an excise tax if you put more than your minimum necessary payments into your pension plan.

Has the administration looked at all about perhaps enhancing the deductibility of corporate contributions to their pension plans?

Mr. FISHER. Yes, Mr. Chairman. The administration has said that we are prepared to review the deductibility after we get to accurate measurements. We don't think it is appropriate to have their cake and eat it, too, to have measures of funding as you have described of current liability, suggesting they are fully funded, when deep down on some other basis we realize they may not be as well funded.

If we can get to a shared understanding of an accurate measure of the liability, then we are prepared to review the deductibility to try to provide a smoothing—excuse me, that is an inappropriate term—— [Laughter.]

Less volatility in funding provided by companies. So we are prepared to review that. One does have to take care in designing those rules, especially for small companies——

Senator FITZGERALD. There can be abuses.

Mr. FISHER. There can be abuses, and that is something the IRS and the Treasury will look out for. But we are prepared to review all those rules in the context of accurate measures of liabilities.

Senator FITZGERALD. Senator Akaka, I don't know if you have any questions.

Senator AKAKA. Thank you, Mr. Chairman. I just have three more questions.

Secretary Fisher, the administration's proposal would use corporate bond rates for calculating future pension liabilities. As a result, businesses would be able to make smaller contributions to worker pensions and assume a higher rate of return. There are concerns that this proposal could drive pension deficits higher at the expense of workers' pension savings. American taxpayers would be at risk if PBGC is underfunded and cannot pay the claims of failed pensions.

What will it cost taxpayers if PBGC cannot pay the amount necessary to cover pension claims?

Mr. FISHER. Senator, if I could take your question in two parts, first, I want to be very clear that the administration does not support simply using a corporate bond rate. If we simply took a single long-term corporate bond rate, it would have the implications that you suggest of potentially leading to underfunding.

We feel, however, if you tie that to the use of the yield curve, as I have outlined, then we will get to better funding over time and

more accurate funding for those plans with younger or older workforces. They will be appropriately funded. So the two go together.

As the colloquy has already, I think, demonstrated, as has been brought out, the PBGC does not carry the full faith and credit of the United States. It is a government corporation, but does not have a call on the Treasury. So any underfunding of the PBGC, its deficit, which began to eat into its ability to meet its obligations, would be an issue that would be before Congress. It would be up to the then-Congress, together with the administration, to decide on whatever legislation would be needed.

But in the absence of adequate funding to meet payments, which we don't foresee in the immediate future, but given the current deficit looks to be in the years ahead, in the absence of that, something would have to give. Congress would have to enact legislation.

Senator AKAKA. Thank you, Secretary Fisher.

Director Kandarian, the management consulting firm Towers Perrin estimates that the administration's proposal to alter funding rules could cut pension contributions by $50 billion annually during the first 3 years, which would leave more pensions underfunded.

The question is, in your opinion, what effect would the administration's proposal have on PBGC's deficit?

Mr. KANDARIAN. As Mr. Fisher has just testified, really, what we are trying to do is get the accurate measure of these liabilities. So if we can get that right measure utilized, over time, we believe these plans will be better funded.

Now, I will also say that the administration's proposal and other proposals up on the Hill contemplate a long-term corporate bond rate for 2 years, which is not the administration's long-term proposal but it is a transition proposal, and yes, that would provide some funding relief in the short term, but we think that makes some sense given current economic situations, environment.

Senator AKAKA. Mr. Kandarian, you and the Comptroller General testified 2 weeks ago before the House Committee on Education and the Workforce. At the hearing, Mr. Walker recommended that Congress consider ways to strengthen the funding of pension plans and to improve transparency by making information available to workers on the health of their pension plans. What are your views on these recommendations?

Mr. KANDARIAN. Well, as I mentioned before, we welcomed GAO's analysis. We have read it carefully. The administration, as Mr. Fisher has noted, is currently undertaking the task of fundamental review of the entire system, including the funding rules and including a number of factors, and we hope to have our proposal, our broader proposal outlined in the not-too-distant future.

Senator AKAKA. I thank you, Mr. Secretary and Mr. Director, for your responses. Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you, Senator Akaka.

Mr. Kandarian and Secretary Fisher, thank you so much for being here. We will take your written testimony and submit that for the record. Secretary Fisher, we wish you the best of luck after you leave the Treasury at the end of this month. As I said at the start of the hearing, I think you have done a wonderful job and

should be commended for it, so best of luck to you. Thank you both very much for testifying.

Now, we can bring the second panel of witnesses up to the table and we will take about a two-minute recess just so that people can stretch before we start with their testimony. Thank you.

[Recess.]

Senator FITZGERALD. I would now like to resume our hearing, and I would like to introduce our second panel of witnesses.

Christopher O'Flinn is the Chairman of the ERISA Industry Committee and he serves as the Vice President of Corporate Human Resources at AT&T. Mr. O'Flinn also is a trustee of the Employee Benefits Research Institute and a member of the Advisory Council on Pensions to the New York State Controller.

Kathy Cissna is the Director of Retirement Plans for R.J. Reynolds. She is here today to testify in her capacity as a board member of the American Benefits Council, ABC, which represents Fortune 1000 companies and service providers. ABC's members either sponsor directly, administer, or service retirement, health, and stock compensation plans covering more than 100 million Americans.

Professor Norman Stein, who I gather his mother lives in Illinois, he told me, is here today. Did you grow up in Illinois? Were you born in Illinois?

Mr. STEIN. Well, it depends when you think childhood ends. I was 21 when my parents moved here, but they would say I grew up there.

Senator FITZGERALD. You left when you were 21?

Mr. STEIN. No, I moved there when I was 21.

Senator FITZGERALD. Oh, you moved there when you were 21. Well, that is still enough to make you an honorary constituent, even though I gather you are in Alabama.

Professor Stein is here today to speak on behalf of the Pension Rights Center. He is currently the Director of the Pension Counseling Clinic and the Douglas Arant Professor of Law at the University of Alabama.

John Parks is the Vice President of the Pension Practice Council for the American Academy of Actuaries. In addition, he is the President of MMC&P Retirement Benefits Services and is an enrolled actuary with 41 years of experience in the actuarial and employee benefits field.

J. Mark Iwry is a non-resident Senior Fellow in the Brookings Institution's Economic Studies Program. Mr. Iwry served as benefits tax counsel of the U.S. Department of the Treasury from 1995 to 2001. Prior to joining the Treasury Department, he served as a partner in the law firm of Covington and Burling and specialized in pensions and other employee benefits.

Again, I would like to thank all of you for being here to testify. In the interest of time, the Subcommittee would appreciate it if you could submit your full statements for the record and try and summarize your full statements in about a 5-minute opening statement. You could talk off the top of your head, as I am sure each of you are able, because you know this area so well, and we would appreciate that.

Mr. O'Flinn—I know a lot of Flinns. I have never met an O'Flinn, but I gather that is probably Irish, like Fitzgerald.

TESTIMONY OF CHRISTOPHER W. O'FLINN,[1] VICE PRESIDENT, CORPORATE HUMAN RESOURCES, AT&T, ON BEHALF OF THE ERISA INDUSTRY COMMITTEE

Mr. O'FLINN. Your guess is correct, Mr. Chairman. Let me add that my son is about to become a constituent when he moves to Chicago on the first of October.

Senator FITZGERALD. Oh, great.

Mr. O'FLINN. Thank you for the opportunity to address the Subcommittee on behalf of ERIC. ERIC has a unique interest in today's hearing. Our members are all large employers who sponsor defined benefit plans, and as a group, they actually pay the bulk of the premium taxes collected by the PBGC. So our overriding interest is in maintaining both a vital defined benefit plan system and a financially sound PBGC along the lines that the Chairman outlined at the beginning of the hearing.

If we have a message that we would like to leave with the Subcommittee today, it would be that any delay in enacting a composite corporate bond rate as a replacement for the 30-year Treasury bond which takes effect in January 2004 for the current liability test will prevent firms from contributing to the economic recovery and will drive even the largest U.S. companies away from the defined benefit system.

We think that failure to act to replace the 30-year bond means that many companies will face totally unnecessary and draconian cash calls beginning in the spring of next year. And moreover, as we speak today, chief financial officers across the country are being advised of the likelihood of these cash calls, and that is having a chilling effect on continued benefit accruals, Mr. Chairman, under the defined benefit system, and also a chilling effect on other alternative uses for that cash, including investment in new jobs and investment in all capital investment, which is essential for our continued recovery.

In other words, we think the time to act to replace the 30-year bond is now and only then will we have a stable platform of rational interest rates to move forward to consider other challenges in the pension law, some of which were very well described by Director Kandarian and Secretary Fisher.

I would like to turn to the PBGC itself and echo the words of Minister Wicks that crisis is a word that should be used very carefully. We think that, as Secretary Fisher said when he began his testimony, there are issues and they are manageable now if we address them. Our concern is not that the issues are wrong or not there, but that they be addressed in a logical way that gives light to all the connected issues around them.

Our written testimony goes into greater detail. I would like just to mention a few points in that testimony.

First, even after becoming trustees of the Bethlehem Steel plan, the PBGC has a funded ratio of over 90 percent. And according to

[1] The prepared statement of Mr. O'Flinn with attachments appears in the Appendix on page 72.

our calculations, as supplemented by the American Society of Pension Actuaries, the assets of the PBGC divided by the current level of benefits, inflated as they are, are sufficient to pay, continue to pay benefits for approximately 18 years. That is assuming no growth in the assets and no additional premiums.

In other words, Mr. Chairman, while this can be compared by some people to the S&L debacle, we don't agree with that. We think it is a little bit early to use that kind of description. The agency is not insolvent. It is a long way from becoming insolvent. And yet, there are issues and they are serious issues affecting the pensions of Americans, including our employees, and we are concerned about them. But we want to move deliberately because of the related and consequential effects of some of the things being proposed by the administration.

I would only mention a couple of these in the interest of time, but one of them is that the interest rate not only affects perhaps the premium structure of the plan and perhaps what might be the funding for corporations, but it affects the benefits of the employees who are relying on the PBGC to pay benefits.

If the PBGC uses an overly conservative interest rate to discount—to arrive at the present liabilities of the benefits it has taken on, it will allocate more assets than necessary to pay for the guaranteed benefits, which has the highest order of priorities, or one of the highest order of priorities against the assets, leaving less assets available for the non-guaranteed benefits, meaning that those benefits won't get paid to the employees. So it is very important to get this discount rate right for all of the people who are interested in the calculation, and that is not only the PBGC and the plan sponsors but the employees themselves.

Thank you, Mr. Chairman. I would be delighted to answer questions.

Senator FITZGERALD. Thank you, Mr. O'Flinn. Ms. Cissna.

TESTIMONY OF KATHY ANNE CISSNA,[1] DIRECTOR OF RETIREMENT PLANS, R.J. REYNOLDS, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL

Ms. CISSNA. Mr. Chairman, thank you for the opportunity to appear today on behalf of the American Benefits Council, which is, as you said, a public policy organization representing principally Fortune 500 companies and other organizations that assists employers of all sizes in providing benefits to employees.

Like you, the Council and its members are very concerned about the health of our defined benefit pension system, a system that is facing an unprecedented series of threats that require immediate policy action.

In our view, the most pressing of these threats is the need to replace the obsolete 30-year Treasury bond interest rate for pension calculations with a realistic rate. Because of the discontinuation of the 30-year Treasury bond, its yield has reached historic lows and no longer correlates with rates on other long-term bonds. The use of this rate inflates pension contributions in excess of what is necessary to fund promised benefits.

[1] The prepared statement of Ms. Cissna appears in the Appendix on page 98.

In 2003 and 2004 alone, contributions by Fortune 1000 companies are projected to exceed $80 billion per year, more than four times what was required just 2 years ago. More than half of these contributions are attributable to the inflationary effect of the broken 30-year Treasury rate.

Today's artificially inflated funding requirements harm employees, employers, and the economy at large. Facing pension contributions many times greater than anticipated, employers are having to defer steps such as hiring workers, building new plants, and pursuing research and development. For some employers, these inflated pension contributions are too much to bear and they have been forced to terminate or freeze their pension plans.

The Council strongly endorses replacing the obsolete 30-year Treasury rate with a blend of high-quality corporate bond rates. A conservative corporate bond rate would be transparent, not subject to manipulation, and provide the kind of predictability that is necessary to plan pension costs. The use of a corporate bond rate, which is much more conservative than what pension funds will actually earn, would also ensure that plans are funded responsibly.

This is why stakeholders from across the ideological spectrum, from business owners to organized labor, agree that a corporate bond rate should replace the 30-year Treasury rate.

Senator Judd Gregg, Chairman of the Health, Education, Labor, and Pensions Committee, has introduced a bill, S. 1550, that would do exactly that. We urge the Members of this Subcommittee to cosponsor S. 1550 and we recommend its prompt adoption by the Senate.

Separately, the Treasury Department has put forward a proposal to utilize the so-called yield curve concept to replace the 30-year Treasury rate. While a fully-developed yield curve proposal still has not been issued, it does appear to involve a significant change to a more volatile and complicated structure under which the applicable interest rates would vary with the schedule and duration of payments due to each plan's participants.

We believe the yield curve and the associated proposals to eliminate interest rate averaging would exacerbate funding volatility and increase complexity, all for only a marginal potential increase in accuracy.

Despite inclusion in legislation to be considered by the Senate Finance Committee as soon as Wednesday, there are still a host of unanswered questions created by the yield curve. In fact, the development of the methodology for developing the yield curve is yet undefined, as is its impact on funding rules in general or plans or participants. It leaves employers with many unanswered questions and is unrealistic to believe that all of the outstanding issues could be addressed in the short time available.

To the extent that this type of major overhaul of our pension funding rules is considered, it should be done as a part of a more fundamental and thoughtful review by Congress. In the interim, we should be cautious of enacting the yet unexplored yield curve approach, but should move urgently to replace the 30-year Treasury rate with a corporate bond blend before any more American workers are frozen out of secured pensions.

I also want to briefly address the concerns that we have heard raised about the financial status of the PBGC. While the PBGC's deficit should be considered seriously, we do not see cause for alarm. Indeed, the PBGC has operated in a deficit position throughout much of its history.

The PBGC has total assets in excess of $25 billion and earns money from investments on those assets. While the liabilities, as we have heard, exceed those investments, the pension obligations underlying those abilities come due not immediately, like the situation might have been in the S&L crisis, but over many decades. The relatively modest size of the PBGC's deficit in relation to its assets ensures that it will remain solvent far into the future, a point that the PBGC itself has acknowledged repeatedly.

The best recipe for a stable PBGC is to encourage healthy companies to remain in the defined benefit system, an aim that will be furthered by the policy changes we are advocating today.

Thank you for this opportunity to appear, and I would be happy to answer questions.

Senator FITZGERALD. Thank you very much. Professor Stein.

TESTIMONY OF NORMAN P. STEIN,[1] LAW PROFESSOR, UNIVERSITY OF ALABAMA, ON BEHALF OF THE PENSION RIGHTS CENTER

Mr. STEIN. Mr. Chairman, Members of the Subcommittee, I am Norman Stein. I teach at the University of Alabama School of Law and also direct the law school's pension counseling clinic, whose funding from the Administration on Aging has made it possible for us to help hundreds of individuals with their pension problems. I appear here today on behalf of the Pension Rights Center, a consumer organization dedicated to protecting the pension rights of workers and their families.

The issues you are looking at today fuse together broad issues of economic and social policy with arcane concepts of actuarial science. But these issues are critical, not only to the participants in defined benefit plans and to their families, but also to the economic and moral health of our Nation. The decisions that we make about this program today will determine the long-term sustainability of the traditional defined benefit plan, which is a crown jewel of our private sector retirement system.

The first question I want to address briefly is whether the Pension Benefit Guaranty Corporation is really in crisis. The PBGC's deficit status is not a new phenomena. As the GAO has reported, over the last decade, the program has swung from a huge deficit to a huge surplus and now back to a deficit. How has this latest swing happened? Conventional wisdom has it that there are three significant reasons for PBGC's current large deficit.

First, economic factors have resulted in the termination of several defined benefit plans with large unfunded liabilities. Second, low interest rates have increased the present value of the PBGC's benefit obligations. Third, the PBGC's investment portfolio has declined in value. Some have called the combination of these three factors a perfect storm.

[1] The prepared statement of Mr. Stein appears in the Appendix on page 116.

But how long will this perfect storm last? Two of the three storm fronts, low interest rates and low equity returns, may be transitory. Interest rates might rise and equity markets might rebound. If this happens, the PBGC's financial situation might improve dramatically and this perfect storm may turn out to have been the perfect tempest in a teapot.

I want to turn now to funding of defined benefit plans. The current funding rules for defined benefit plans have not proven adequate to ensure that all defined benefit plans will be sufficiently well funded to satisfy their benefit commitments. I want to highlight two observations from our testimony, and not the observations where we happen to agree with the witnesses who just spoke but the two where we differ.

First, some have suggested that the interest rate for discounting plan liabilities be increased from the 30-year Treasury rate to long-term corporate bond rates. The result of such a change in many cases would be a reduction of a firm's plan contributions and an exacerbation of plan underfunding. We would urge that the appropriate discount rate should be pegged to riskless or nearly riskless instruments, such as government-issued bonds, because after all, the participants in the system perceive their guaranteed benefits as being without risk.

The inappropriateness of the corporate bond rate can be put in perspective by looking at how the use of such a rate would affect PBGC's own liabilities. I have spoken with several actuaries who estimate that such an alchemic change would reduce PBGC's aggregated liabilities by between 5 and 15 percent, substantially reducing or perhaps almost eliminating the PBGC's current deficit, which after all is the reason we are here today.

Second, the administration has proposed that plan liabilities be discounted to present value using a yield curve derived from interest rates on high-quality corporate bonds. For some plans, a yield curve based on corporate bond rates would actually reduce funding obligations, which we think is counterproductive to the goal of improving overall plan funding. For other plans, those with a mature workforce and many retirees, a yield curve would substantially increase funding and perhaps force bankruptcies and create job loss in important sectors of our economy.

I want to turn now briefly to some of our observations on other issues relevant to the PBGC. First, to strengthen the PBGC, Congress in the future might consider allocating appropriations to the PBGC from general revenues. Such appropriations are, we believe, justifiable, since many of the funding issues that defined benefit plans are today experiencing have resulted from the low interest rates created by Federal fiscal policy and the decision by the Federal Government to stop issuing 30-year Treasury obligations. And as you have already suggested, Mr. Chairman, to some extent, we have a tax today already, but it happens to be on those people who sponsor healthy defined benefit plans and it might be fairer to have that burden spread to a broader tax base.

Second, to stem the flight of employers from the defined benefit system and leaving the system's unfunded liabilities for those employees who remain in the system, we might also consider imposing

an exit charge or withdrawal liability when firms terminate their defined benefit plans.

Third, rules should be adopted to deter practices where firms siphon off plan assets to non-pension purposes in years when economic conditions are favorable, thus diminishing the plan's cushion for harder economic times.

Finally, some have suggested reducing the interest rates used to value single-sum payments from pension plans. While the Pension Rights Center has never been an advocate of lump sum distribution options, it has always taken the position that once a firm promises an employee a benefit, it should not be able to break that promise.

Employees view pension plans as contracts and the interest rate used for valuing lump sums is a part of those contracts. Those who would change the interest rates are, in effect, asking Congress to relieve them of the bargain they made with their workers.

I would be happy to take any questions. Thank you.

Senator FITZGERALD. Thank you, Professor. Mr. Parks.

TESTIMONY OF JOHN P. PARKS,[1] VICE PRESIDENT, PENSION PRACTICE COUNCIL, AMERICAN ACADEMY OF ACTUARIES

Mr. PARKS. Chairman Fitzgerald, thank you for inviting me to testify on defined benefit pension plan funding. It is a personal honor of a lifetime for me to be here.

My name is John Parks and I am Vice President of the Pension Practice Council of the American Academy of Actuaries. The Academy is a nonpartisan public policy organization that represents actuaries and assists the public policy process through the presentation of clear and objective actuarial analysis.

The combined impact of the decline in the equity market and reduced interest rates are currently creating a funding challenge for defined benefit pension plans in our country. It is important also to remember that for at least the last 10 years, there has been a steady shift away from the guaranteed retirement income from defined benefit plans and toward the self-annuitization through defined contribution plans.

The danger in this transfer of financial mortality risks to individuals is largely unseen because the people affected have mostly not yet retired. We must deal, therefore, not only with the current financial conditions, but also with the longer-range challenges facing defined benefit plans in general.

It is a critical part of this retirement economics challenge to see that defined benefit plans are supported and plan sponsors are provided with the incentive to maintain and cultivate these programs. Some special advantages of these plans include, for employees, a secure, stable income guaranteed for life, and a reduction in the spreading of mortality and investment risk. For employers, these plans provide contribution flexibility and maintain a stable workforce. For the Nation, defined benefit plans help to reduce our dependence on social programs, such as Medicare, Medicaid, and Social Security, and they reduce poverty among the elderly.

[1] The prepared statement of Mr. Parks with attachments appears in the Appendix on page 125.

In 1975, just after the Employee Retirement Income Security Act we signed into law, 40 percent of the labor force participated in DB plans and 16 percent participated in a DC plan. Today, however, the reverse is true. Only 21 percent participate in a DB plan while 46 percent participate in defined contribution plans. Our concern is not just the funding of DB plans. Our concern is the survival of the DB plans as a primary source of financial security for retirees.

The first issue I would like to discuss is funding. We must simplify the rules. Years of almost annual amendments to ERISA have continually increased the administrative burdens on those who try to maintain defined benefit programs. Those companies who sponsored DB plans are now questioning the future of their programs under the current financial strains of the economy, mandated rigid and short-range irrational minimum and maximum funding requirements, arcane pension laws and regulations. Simplification is necessary to reduce the regulatory cost of DB plans and level the playing field and provide a viable system with stable rules to attract new plan adoption, all of which are needed to meet the financial security of retiring Americans.

Just one quick example. There are 13 different amortization rules for paying off liabilities in the funding code under Internal Revenue Code Section 412. Our suggestions include complete rewriting of the minimum funding standards and providing for fewer and faster amortization periods.

The second funding concern is the maximum tax deductible contribution limitation. These funding rules create volatile contribution patterns and discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong and require substantial contributions when the economy declines and plan sponsors can least afford them. Some of our suggestions for revising these rules include increasing tax deductible contribution maximum to reflect increases in unfunded liability, allowing all negotiated benefits to be reflected, reflecting lump sum payments in current liability, and allowing a deduction for normal costs in all years.

The next funding concern are the rules relating to withdrawals from pension plans. Incentives for employers to increase their funding margins may not work unless we also address the one-sided nature of the funding equations. Employers who try to protect the plan by making additional contributions have very little opportunity to use those contributions if it turns out they weren't needed. Our suggestions would be only to allow reversions if assets exceed some very high threshold, such as 150 percent of current liability.

Fixing the discount rate—current law defines this interest rate in terms of 30-year Treasury notes. This rate is used for the determination of cash contributions, variable PBGC rates, and other key pension calculations. They have been artificially depressed, rising the current measure of costs associated with plans. Our recommendation is that a replacement benchmark using high-grade long-term corporate bonds is a reasonable proposal consistent with the intended measurement. However, while the various funding rules are studied, the period of temporary enactment should be 5 years rather than 2 or 3 years as proposed.

In summary, defined benefit plans, once the most common form of retirement security for American workers, have lost much of their attraction for corporations. The exodus of the PBGC premium payer, a risk that has not been receiving proper attention regrettably continues. The complicated solvency rules with 3 years of low interest rates and market returns have created a funding crisis. At the same time, plan participants are starting to appreciate the value of being covered under a DB plan. The high risk of personal ruin through self-annuitization is yet to be fully realized.

In our haste to fix the funding crisis, we must be careful not to create an environment that discourages the continuation of existing DB plans. Thank you.

Senator FITZGERALD. Thank you very much, Mr. Parks. Mr. Iwry.

TESTIMONY OF J. MARK IWRY,[1] SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. IWRY. Thank you, Mr. Chairman. Having spent much of the previous decade in the Treasury Department regulating private pensions and benefits, including involvement in the previous efforts a decade ago to reform the pension funding rules and shore up PBGC's finances, I am convinced, Mr. Chairman, that Congress does have to act both in the short- and long-term here, but that there is no "silver bullet," no simple solution to these problems. That is because Congress has to take into account several different interests that are highly legitimate, that are in tension with one another, and that must be balanced against one another.

Congress needs to begin with short-term funding relief and then follow on with permanent, comprehensive improvement of the funding rules that would specifically require more adequate funding over the long term to protect workers' retirement security, with special attention to reducing chronic underfunding. And as Mr. Kandarian and Mr. Fisher suggested, Congress needs to improve disclosure, both the transparency and the promptness of disclosure regarding the material facts of pension plan funding.

At the same time, Congress needs to take into account the potential impact of large funding demands on a plan sponsor's overall financial condition and on economic growth. It has to minimize funding volatility for plan sponsors so that the required increases in funding from year to year follow a reasonably smooth path.

As Mr. Kandarian has said, the deficit reduction contribution, that is, the minimum funding requirement that is accelerated when a plan falls below a certain funded threshold, is too volatile. It starts too late. It ends too early. The funding path it puts plans on is not optimal.

The targets that the deficit reduction contribution are keyed to need to be revisited. The rules allow inappropriate holidays to companies that should be contributing, as the Bethlehem Steel case illustrates. And employers are precluded from funding for lump-sum distributions even if those impose higher liabilities than the annuities that employees could elect. IRS administrative guidance, notice 90–11, precludes the company from actually taking into account the value of the lump-sum distribution to the extent that it

[1] The prepared statement of Mr. Iwry appears in the Appendix on page 142.

might impose more of a funding obligation than a life annuity, and that needs to be fixed.

While doing all of this, Congress needs to protect the reasonable expectations of employees and retirees with respect to their promised benefits, and to the extent possible, avoid discouraging employees from continuing to provide pension benefits. We also need to avoid penalizing those plan sponsors that are funding their plans adequately and that are, like the PBGC, not part of the problem but, in fact, part of what is right with the system.

More generally, we need to continue encouraging employers to adopt and to continue maintaining defined benefit pension plans. This may suggest an emphasis on requiring sponsors to fund adequately in preference to directly restricting their ability to provide benefit improvements and in preference to curtailing the PBGC's guarantee.

To that end, I think that the defined benefit system would benefit from a resolution of the cash balance controversy that would settle the law governing these plans in a reasonable way.

A major portion of the defined benefit universe in recent years has taken the form of cash balance plans, as hundreds of plan sponsors have shifted from the traditional defined benefit plan to this new hybrid format. The precise application of the governing statutes to these plans has been the subject of uncertainty, litigation, and controversy, as you know, Mr. Chairman.

I suggest that Congress could and should resolve the cash balance controversy in a way that gives older workers substantial protection from the adverse effects of a conversion while allowing employers to maintain cash balance plans without concern that they would be treated as if they were age discriminatory or otherwise in violation of the law, and that allows employers the reasonable flexibility that they need to change their plans, to make amendments going forward, and the flexibility they need to determine how, but not whether, to protect older workers in these conversions.

I will be happy to answer any questions, Mr. Chairman.

Senator FITZGERALD. Thank you very much, Mr. Iwry.

Ms. Cissna and Mr. O'Flinn, Mr. Iwry suggested that he felt that Mr. Kandarian and Secretary Fisher were correct in calling for enhanced disclosure and transparency. What is wrong with enhanced disclosure and transparency insofar as don't we want pension plan beneficiaries to know the status of the plans they are in and don't we want shareholders of a corporation to know the full extent of any problems that a company may have in an underfunded pension plan?

Ms. CISSNA. I think it would be erroneous to say that anybody is not in favor of accurate disclosure. I think the only thing that concerns Council members is that good transparent disclosure be properly representative to the people it is being directed to.

I personally, as a plan sponsor, as a plan administrator, am concerned that certain levels of panic could be created by inappropriate disclosures to the extent that participants in a plan might begin doing irresponsible things, like taking lump-sum distributions when perhaps that is not in their best interest, because as you mentioned yourself, the rules for how you determine what is

underfunding are so complicated that most of our participants don't really appreciate them.

Senator FITZGERALD. Mr. O'Flinn.

Mr. O'FLINN. I would agree with Kathy's comments, Mr. Chairman. First of all, I would also agree with the prior panel that there is a need for additional disclosure. For example, under the current disclosure rules dictated by FASB, you would be hard pressed to estimate the future cash contributions required to the plan. So if you were interested in the free cash flow of the company, you basically might be missing a big element unless you hired actuaries to dig through the material and make their own estimates.

So we would agree, there is need for additional disclosure. The particular disclosure that—we think that we would like to hear what FASB has to say about that. They are aware of these problems. They have an ongoing task force addressing them. If there is a theme to the overall hearing, Mr. Chairman, that we think fits here, it is what is the rush? Let us let the experts fully flesh out everything that happens from what is being proposed here before we commit to a specific set of actions.

And in terms of the termination benefits, termination benefits basically evaluate the plan as if everyone is leaving the day of the valuation. So all of the early retirement benefits, which normally would not be used, since most people retire later than the early retirement benefits, come into play and explode the liabilities of the plan.

Senator FITZGERALD. But when a plan terminates, don't you often have people leaving, people retiring early, taking money right away? So if the company goes bankrupt and terminates its plan, don't you have a flood of claims all of a sudden on the plan?

Mr. O'FLINN. Yes, you do, but let me take some figures from the PBGC's last annual report. They ensure $1.5 or $1.6 trillion in benefits and approximately $35 billion of that, which is a little bit more than 2 percent, is underfunding attributable to so-called financially weak companies. Now, for disclosure on those 2 percent, should everyone behind the $1.6 billion [sic] do an evaluation and publicize it as if they were going to go out of business tomorrow when the likelihood of that happening is extremely small?

Senator FITZGERALD. Mr. Iwry.

Mr. IWRY. Mr. Chairman, I think that the representatives of the ERISA Industry Committee and the American Benefits Council have a responsible and legitimate concern regarding the risk of a type of disclosure that would be not constructive and not helpful and potentially not cost effective. But I do think there is a reasonable middle ground here.

We certainly need to improve disclosure and there are at least two specific ways in which that could realistically happen. One is where companies are already sponsoring very underfunded plans. Right now, it is an aggregate of $50 million of underfunding, which perhaps should be made more sensitive to the actual extent of underfunding as a percentage rather than just the absolute amount and maybe even sensitive to the financial condition of the plan sponsor.

But we now have these disclosures that you alluded to earlier that are confidential and that to the PBGC when underfunding has

exceeded a certain amount. Those ought to be made public, but not to the extent they would compromise proprietary corporate information, and that is a large part of the concern that the plan sponsors have. You can disclose the funded status of the plan. You can disclose the assets and liabilities without disclosing the company's own finances in a way that isn't already required to be disclosed by law.

Second, you can disclose liabilities in a more accurate way.

Senator FITZGERALD. Isn't the problem that the financially weakest companies don't want that information disclosed because then everybody would know how weak they are?

Mr. O'FLINN. That is right, and I think also some financially stronger companies don't want certain information disclosed because of competitive considerations, where the securities laws and other rules already require a certain amount of disclosure. But certainly, we can have much improved disclosure of the plans' funded status, not just information provided to the PBGC, but provided to employees, investors, and everyone else.

And then you could have termination liability, which as you indicate, is often a realistic depiction of what would happen if the plan actually terminated in the near future, reflecting early retirements and plan shutdowns that don't get taken into account under current, so-called current liability determinations. You can have this termination liability as an additional disclosure for companies that are less solid. That is, one could consider whether termination liability ought to be required to be disclosed once a company is either below investment grade in its ratings or is otherwise—or is relatively underfunded in its pension plans. In other words, once a company ceases to be sound and soundly funding its plan, employees have a different degree of interest in knowing what might happen in the then somewhat more realistic scenario that the plan would terminate.

Senator FITZGERALD. Professor Stein, you said in your opening statement that you believed that we should not adopt a high-grade corporate bond discount rate, that it should be based on as riskless a rate as possible, on a Treasury note of some kind. Given that we are losing the 30-year Treasury bond, that it is being done away with and that it is more and more scarce, are you suggesting that we start using intermediate grade Treasuries as a discount rate?

Mr. STEIN. Well, my solution would be to begin reissuing 30-year Treasuries and, in fact, reissuing bonds of even longer duration. I think the government's decision to stop issuing 30-year Treasury bonds, I think has had perhaps some good consequences, which are some speculative potential good consequences down the road, but I think they have also created problems, particularly in the area of pension plans.

I think also for funding, there is some discussion now among actuaries about whether plans should be funded in a way similar to what the yield curve suggests, that there should be more of a matching of assets with liabilities, and if that is to happen, a lot of the way it is going to happen is because the government starts issuing notes of longer duration.

Senator FITZGERALD. What happens, Ms. Cissna, if we do adopt a high-grade corporate reference and then all of a sudden the 30-

year Treasury does come back? After all, Secretary Fisher is leaving the Treasury at the end of the month and I think he was one of the people who was behind doing away with the 30-year Treasury. Then would you stick with the high-grade corporates or would you want to go back to the 30-year Treasury, even though it would increase your payments? Wouldn't that be a better——

Ms. CISSNA. Well, I think that that is somewhat hypothetical and I am not sure that I am in any means able to answer a hypothetical question like that. I still think that you have to focus on the fact that the high-grade corporate bond rate is still a very conservative rate when compared to the way pension funds are actually going to be invested. And to the extent that you have a divergence between the actual investment ability of the plan and the way you have to value its liabilities, these are the things that are going to lead employers to be afraid of defined benefit plans, afraid of the system, and to look more and more at freezing and terminating plans.

Senator FITZGERALD. Mr. Parks, what do you think of the Treasury's idea for using a yield curve?

Mr. PARKS. Our concern about the use of a yield curve is the implication of complexity in the calculations that it would mandate for each individual and each pension plan. I am not certain that long range, it might be a logical solution, but the current set of funding rules as it relates to defined benefit plans are already a collage of confusion, and I am afraid that this imposition of the yield curve without knowing the implications of all those confusing calculations that are currently necessary is premature and we would like to have the opportunity to study it in depth.

Senator FITZGERALD. But it is true that it is now considered a best practice, isn't it, in the actuarial world to try and match the liabilities with a similarly maturing asset, is it not?

Mr. PARKS. I believe that is a best practice in the financial world. I am not sure that from the perspective of the actuarial implications in a defined benefit pension plan we yet know that.

Senator FITZGERALD. Would it concern you that if we don't use a yield curve, we would just be adopting a higher discount rate from corporate Treasuries than we have now with the government risk-free Treasury bonds? If we just adopt a corporate bond rate as our discount rate, we are just allowing companies to put a whole lot less into their pensions, aren't we?

Mr. PARKS. Well, you can adopt a corporate bond discount rate, adjusted in some way to compensate for that, such as subtracting a certain amount of basis points or multiplying by a percentage.

Senator FITZGERALD. I don't think that is what these companies have in mind. [Laughter.]

Ms. CISSNA. Mr. Chairman, if I could interject, I think that our position would be that, as I mentioned, the corporate bond blend is still a conservative approach to valuing the liabilities of vibrant pension plans, and the more that we can do to continue to support the defined benefit system and to continue to allow employers to fund responsibly without being burdened by the volatility and the unpredictability that may be established through the use of a yield curve, we are going to be better off.

Senator FITZGERALD. I wonder if Mr. Parks would like to comment—I gather you have some great familiarity with ERISA. You have to deal with it. Actuaries have to actually plod through the statute and figure out what some of the definitions, such as current liability, mean. The case of Bethlehem Steel illustrates this well—in its last filing, Bethlehem Steel on a current liability basis was 84 percent funded. But then when the PBGC took it over, it found that it was actually only 54 percent funded on a termination basis because the problem is that the legislative definition of current liability is really more a political definition as far as I can tell than an actuarial definition.

The bottom line is, current liability under ERISA is something far less than the actual amount of money that needs to be put into the plan to pay the benefits that are owed. Is that accurate? Have you figured out why this is so?

Mr. PARKS. You are correct in analyzing that the current liability definition is extremely complex. Actuaries love complexity, but even to me, it is confusing.

But maybe perhaps the best way to describe it, and in a broad way, the difference between the termination liability and the calculation of current liability, with all of its machinations, is that current liability assumes that the plan is an ongoing entity and termination liability is the end of the line and, therefore, you have to cash in the chips and measure it at one point in time. On an ongoing basis, we can consider factors such as rates of return which reflect the equity markets. But on a termination basis, we have to pay the piper and measure as of this point in time.

Senator FITZGERALD. Well, it seems to make sense, then, to calculate it in both ways, right? Termination basis and the so-called current liability and have disclosure of both in case the plan does, in fact, terminate, like apparently United Airlines is considering terminating and they have a termination liability of $7.5 billion. Would any of you care to comment?

Mr. O'FLINN. I would, Mr. Chairman. First, Bethlehem Steel and all the steel companies got some relief from the funding rules when they were last revised in 1994, and to the extent that contributed to their underfunding, I think it is a little unfair to say the current law, which essentially does not completely apply to them, is a reason for changing the current law.

In terms of the disclosure, I wonder what the purpose of the disclosure is. What is the purpose of the vast majority of companies disclosing a liability which the high probability is they will never pay, recognizing that it could have a chilling effect on even creating that liability, which has certain legitimate purposes. In other words, a lot of the liability is early retirement benefits and they are very beneficial to people who are being laid off from an ongoing concern.

Senator FITZGERALD. Don't we want the members in the plan to pressure their companies to better fund their pensions and don't we want to deter companies from promising things to their workers that at the end of the day they can't deliver? Haven't we been going on too long in this country with companies, maybe in union negotiations, saying, hey, we can't give you a raise this year, but I will tell you what. We will sweeten your pension benefits. And

the reality is, they have no ability to ever pay those sweetened pension benefits. Aren't we just allowing companies to make promises that they can't keep, and then when the workers don't get their pension at the end of the day, isn't the rug being pulled out from under them? Mr. Iwry.

Mr. IWRY. Mr. Chairman, that is why I suggest, consistent with what you were saying earlier, that there be disclosure of the liability under both scenarios, that is, ongoing and in the event that the plan terminates—the current liability and the termination liability, or liability on a termination basis—at least in circumstances where the second scenario, that is, that the plan will not continue, becomes more likely. Perhaps it is a reasonable weighing of costs and benefits here to trigger that second disclosure in circumstances where that scenario of termination does become more realistic.

I would add, with respect to your broader point about the negotiated increases, that in devising an appropriate policy to restrain unfunded benefit improvements and to protect the PBGC and ultimately the taxpayers from inappropriate shifting of liability, we do need to take into account, in fairness, that the union plans typically are so-called flat benefit plans. That is, they pay a benefit equal to X-dollars per month for each year that an employee works for the company. If the employee's wages go up, as people's wages normally go up over their career, that formula doesn't keep up with the wage increases or with cost-of-living increases unless it is amended from time to time to increase that dollar amount.

By contrast, in the salaried world, the plans are typically based upon pay. They provide a pension that is a multiple of people's final average salary or career average salary or make contributions in a cash balance plan that are proportional to that year's pay. So they amount to something like career average salaries. So when that plan continues unamended, it is keeping up with inflation and, indeed, it is keeping up with salary increases in a way that the unionized flat benefit plan is not.

And, of course, that has served the purposes of management and unions over the years. The union has been able to negotiate an increase every 3 or 5 years during their collective bargaining and bring that back to their members. But to the extent that it is just keeping up with cost of living or with wage increases, we might want to take that into account when we set a restraining policy there.

Mr. STEIN. There is another side to that. We actually talk about this also in our written testimony. But for the most part, the kind of plans that Mark has just described, negotiated plans and a flat benefit formula, the quirk in the funding rules makes it—means you can't fund these inflationary increases, which we know are going to happen, and in order to kind of treat these plans the same way we would treat final pay plans, you would probably want to address this on both the funding side and the guarantee side.

Senator FITZGERALD. You can't fund benefit increases that are going to take place because of inflation?

Mr. STEIN. In a final pay plan, you effectively can. But in these kinds of plans that Mark is describing, generally, you cannot.

Mr. IWRY. Mr. Chairman, I think our point is—I agree with Professor Stein—the union bargained plan cannot anticipate the future

negotiated increases, even though it is understood that it is likely the plan will be updated to keep up with inflation or wage increases. But until that increase has actually been negotiated and gone into effect, the actuary can't anticipate it in the funding. So the rules are skewed to some degree or structured in a way that has the effect of discouraging adequate funding.

That is not to say that is the only reason. In some cases, management will choose not to fund those plans too much, partly out of concern that if they create a surplus of assets in the plan, then the union will come back and ask for increases because the money is there. So there are a lot of dynamics there.

What I am suggesting is, that in restraining increases that may not be prudent and may not be sufficiently well funded to be fully responsible, we take into account the desire, I think, of everyone on this panel and the previous panel to maintain the health of the overall defined benefit system and to continue encouraging employers to sponsor and improve defined benefit plans.

Senator FITZGERALD. What about all the exemptions and loopholes that have developed in recent years? We talked about Bethlehem Steel not making any payments for 5 years. That was apparently the result of the last time Congress amended ERISA in 1994. It seems like that was a very unwise amendment that we gave at the time. Does anybody know specifically where that exemption is in the law and shouldn't those loopholes be closed? Professor Stein.

Mr. STEIN. There are a number of ways in which both the variable premium structure and the deficit reduction contribution don't work exactly as we would like them, and they tend to be fairly technical.

One problem with the deficit reduction contribution is if a plan has a funding credit, which is a complex idea, but it can date back to contributions that were made years and years earlier, even though the plan now is seriously underfunded, those credits can actually substantially reduce the contributions you would want those plans to make.

But there are—generally speaking, we agree with much of what the PBGC has said in earlier testimony. We think that the variable premium and the deficit reduction contribution need some fixing.

Senator FITZGERALD. Mr. Parks, I know you mentioned in your opening statement enhancing the tax deductibility of, I guess you might call them excess pension contributions and the tax deductibility of which was reduced in the 1990's. Do you have any specific recommendations in that regard? A company, I gather, cannot go over its required contribution before it starts incurring tax penalties?

Mr. PARKS. That is correct, and as a matter of fact, they may even be compelled to pay an excise tax if they contribute in excess of the maximum deductible contributions.

Senator FITZGERALD. Why would we impose an excise tax on somebody doing it? I gather there were problems with small companies maybe dumping money into the executive pension fund, but can't we target a law better? Mr. Iwry, you were at the Treasury Department at the time.

Mr. IWRY. I was, Mr. Chairman, and I think that you may be referring principally to the so-called full funding limitation, which

was imposed more stringently in 1987. Has just been phased down and will be repealed 3½ months from now.

Now, as you might expect from having grappled with the statute before this hearing, there is not just one full-funding limitation, there are two, but the one that had presented the most problems or aroused the most concern on the part of plan sponsors trying to fund fully in good times has been slated for repeal and will go out of existence on January 1. Now, I am not suggesting that that necessarily is enough and that we ought to stop there, but——

Senator FITZGERALD. There are other full-funding limitations elsewhere in the statute.

Mr. IWRY. Yes, and they serve a reasonable purpose. The question is whether they ought to be fine-tuned.

Senator FITZGERALD. It sounds like the whole statute needs to be dramatically simplified, and maybe we should have some actuaries working on this as opposed to politicians. [Laughter.]

Mr. STEIN. There is actually a very interesting article in the recent edition of your magazine, Contingencies, by an actuary called Jeremy Gold, who is sort of an iconoclast, but he has suggested a very simple way of funding plans, which is you basically have a corridor based on current liabilities and you can go so much below it and so much above it, and if you get too far below, you have to start making immediate contributions to bring it up to whatever the minimum target is, whatever the floor is. He says, basically, just establish a floor and ceiling based on the liabilities.

Senator FITZGERALD. But your definition of what your current liabilities are is very important——

Mr. STEIN. That would have to be worked out——

Senator FITZGERALD [continuing]. And I gather there is a lot of mischief in that.

Mr. STEIN. That would have to be worked out and it would be a miracle if you could work it out in a way that avoided complexity.

Senator FITZGERALD. Now, I am not going to go on much longer. The afternoon has been dragging on. You all have been terrific witnesses. But I know, Ms. Cissna and Mr. O'Flinn, you were—I think Mr. O'Flinn specifically—you made a reference to it is really only about 2 percent of the companies that are financially weak and have really badly funded pension plans. That would mean that most companies with defined benefit plans have managed them responsibly, they are in pretty good fiscal shape, and the trouble we are in is resulting from a very small number of bad actors.

I would think, therefore, that it would be in the interest of the 98 percent of companies that are strong and are good actors to get really tough on the ones who aren't, because ultimately, the well-funded plans may have to pick up the tab for the poorly-funded plans in terms of increased insurance premiums to the PBGC.

Mr. O'FLINN. That is a fair characterization, Mr. Chairman. I think in terms of disclosure, something along the lines that Mr. Iwry was describing earlier, we have much less concern with than a broad-brush approach that puts out data that may be misinterpreted and is really irrelevant to a member of the 98 percent.

Senator FITZGERALD. But a company that has a very well funded pension plan, even on a termination basis, I would think they might even want that information out, because then analysts could

see, and their employees could see that it is really well funded. Maybe they wouldn't want their workers pressing for more pension sweeteners, but to some extent, that would help some of the companies. It might remove some doubt about whether a company's pension plan has a severe problem.

Mr. O'FLINN. I think that many companies have early retirement benefits to service a very small portion of the population which can be expected to leave before what you might call expected retirement, and that is their primary purpose. To do evaluation which basically assumes that many more people—virtually all the people are going to use those who qualify for them at the time of the valuation is—I don't know what you would call it, a red herring, something that would involve hours of explanation to people who, frankly, have enough trouble understanding the current liability test now. I am speaking from the employees' point of view.

To explain that there is a government-required number, that, on its face, would raise concern because I don't believe very many companies are funded, well funded on a termination basis, at least the large companies in our organization who maintain robust early retirement benefits. They are funded for how they are expected to use them, but they are not funded on a termination basis.

Ms. CISSNA. Nor do they anticipate terminating.

Mr. O'FLINN. Exactly. They are funded for how they are expected to occur, with the advice of their actuaries and accountants who are monitoring their situation.

Ms. CISSNA. And, Mr. Chairman, if I could add, I think it is also—I think you will agree with me on this, I don't know, but fairly short sighted to assume that the sponsors of reasonably well-funded plans aren't doing a lot of asset liability modeling anyway, looking at when those assets are going to be required, what the payment schedules are going to be. It is not like these things are being ignored completely.

Senator FITZGERALD. Do you think, both Ms. Cissna and Mr. O'Flinn, that your members object if there were a requirement that plans whose funding falls below a certain level be frozen, that they couldn't sweeten benefits anymore, all to shelter the PBGC from further risk?

Ms. CISSNA. Well, freezing is a tough word. I mean, freezing is a lot different also than not enhancing. If you are going to tell my participants that they can't earn another penny after today——

Senator FITZGERALD. Well, if the plan is——

Ms. CISSNA [continuing]. Because on a termination basis, which the plan does not intend to do, it looks somewhat unfunded.

Senator FITZGERALD. Well, I think the administration's proposal is if you are not 50 percent funded on a current liability basis, then you can't sweeten your pensions at all. To me, it should be a much stricter requirement than that. I would think if you weren't 100 percent funded, that you shouldn't be able to sweeten your benefits. I think that would protect the other companies, the 90 percent that are healthy and financially responsible with their plans.

Mr. O'FLINN. We do think that work needs to be done on what liability the PBGC takes over, particularly recently created liability. And, of course, the law has some relief in that regard already. But remember, Mr. Chairman, there are new companies that start

pension plans that are maybe far away from 100 percent funding. So you would have to take into consideration that category, as well. I agree, a well-established plan would aim for probably somewhat higher than 100 percent funding on an ongoing basis, but it may take a while to get there.

Senator FITZGERALD. Professor Stein.

Mr. STEIN. Yes. There is an alternative path which some people have suggested, which is if you have a seriously underfunded plan, to try and develop rules that will allow, as Kathy said, the regular benefits to continue but to ensure that the deficit doesn't grow, that is, all new benefits would have to be immediately funded and the deficit can't become any worse, that is, you amortize the deficit over some period of time, perhaps an extended period of time, which would at least say to the PBGC, this plan can continue. We don't have to prematurely terminate it. Our situation, it might not get better, but at least it won't get worse.

Senator FITZGERALD. Mr. Iwry.

Mr. IWRY. Yes, Mr. Chairman. I agree. We have a 5-year phase-in now, as you know, of the PBGC's guarantee, so that benefits added shortly before termination are not fully guaranteed. Now, that may not go far enough toward protecting the PBGC, but I think the administration's proposal to not only prevent sweetening of benefits, as you say, but to prevent continuation of the existing level of benefits—that is, their proposal to require freezing of additional accruals and suspension of lump-sum payments in excess of $5,000 per person—I think those proposals are probably too draconian, that we ought to be looking at accelerated funding of what are really new promises.

And again, I would suggest taking into account the cost of living updating that occurs automatically in the non-union plans but has to be negotiated periodically in the union plans, putting that into the mix when we think about what the policy ought to be with respect to sweeteners. To what extent is that meeting reasonable expectations of the workers, who, after all, don't control the funding of their sponsors' plans and, of course, don't control the financial condition of their sponsors.

Senator FITZGERALD. We are going to close shortly, and I want to ask one final question. As all of you know, General Motors has taken some dramatic actions to strengthen its pension funds, going to the capital markets to borrow, I gather, $15 billion and having the corporation assume the debt and putting the proceeds in the pension fund. Would anybody care to comment on this strategy and whether other companies should be encouraged to follow?

Mr. STEIN. It has been suggested that there are some accounting benefits, given the way the accounting treatment of pension funding works, that by putting the money in the plan and then assuming a higher rate of return, General Motors will actually be able to have some extra earnings added to its annual operating earnings. But frankly, I would rather see the money in the plan than not in the plan, so whatever its motives——

Senator FITZGERALD. Do you know what percentage funded they are now?

Mr. STEIN. No.

Senator FITZGERALD. OK. They had $15 billion that went a long way, I think, in any case.

Mr. STEIN. Yes, but if their motives are impure, the effects are very good, so God bless them.

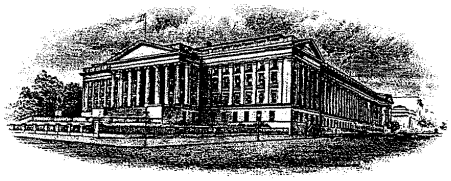
Senator FITZGERALD. OK. [Laughter.]

Well, thank you all very much. You all have been excellent witnesses and we appreciate your time and attention on a complex matter. Thank you for being here. We will keep the record open until the close of business tomorrow, if you would like to have any further statements put in the record or if Senators would like to have further statements put in the record.

Thank you all very much. This hearing is adjourned.

[Whereupon, at 5:01 p.m., the Subcommittee was adjourned.]

APPENDIX



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Embargoed until 2:30 pm EDT
September 15, 2003

Contact: Betsy Holahan 202-622-2960

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

THE ADMINISTRATION'S PROPOSAL FOR ACCURATELY MEASURING PENSION LIABILITIES

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

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

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

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

Reform Issues

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

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

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

1. *Funding Rules*

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

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

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

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

e. *Credit Balances*. If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances - mere accounting entries -- do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.

f. *Benefit Amortization*. The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

2. *Actuarial Assumptions*

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

a. *Mortality Tables*. In order to ensure that liabilities are measured accurately mortality estimates need to be made from the most up to date and accurate tables available. On September 3, 2003 the Treasury and the Internal Revenue Service released to the press Notice 2003-62, a request for comments on the mortality tables used in determining current liabilities. The notice, which will be published in the *Federal Register* on September 22, invites comments on methods of projecting mortality and on factors, in addition to age and year of birth, that might be appropriately reflected in any new tables that may be adopted.

b. *Retirement Assumptions*. Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.

c. *Lump Sums*. Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.

3. *Other Issues*

Three other issues also deserve review:

a. *Extent of Benefit Coverage*. It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.

b. *Multi-employer Plan Problems*. Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.

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

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

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

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

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

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

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

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

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

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

The Importance of the Discount Rate in Pension Funding

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

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

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

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

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

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

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

Pension Discounting under Current Law

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

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

The Administration's Proposal for Accurately Measuring Pension Liabilities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Concluding Observations

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

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

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

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

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

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

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

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

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

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

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

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

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

2 - See Financial Accounting Standard 87.

STATEMENT OF STEVEN A. KANDARIAN
Executive Director
PENSION BENEFIT GUARANTY CORPORATION
Before the
GOVERNMENTAL AFFAIRS COMMITTEE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY
UNITED STATES SENATE
SEPTEMBER 15, 2003

INTRODUCTION

Mr. Chairman, Ranking Member Akaka, and Members of the Subcommittee:

Good afternoon, I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing on pension funding and the financial health of PBGC, and for your continuing interest in the retirement security of America's workers.

PBGC was created as a federal corporation by the Employee Retirement Income Security Act of 1974 (ERISA). PBGC protects the pensions of nearly 44 million workers and retirees in more than 32,000 private defined benefit pension plans. PBGC's Board of Directors consists of the Secretary of Labor, who is the chair, and the Secretaries of the Treasury and Commerce.

PBGC insures pension benefits worth $1.5 trillion and is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. As a result of the recent terminations of several very large plans, PBGC will be responsible for paying benefits to nearly 1 million people in FY 2003. Similarly, benefit payments that exceeded $1.5 billion dollars in FY 2002 will rise to nearly $2.5 billion in FY 2003.

Defined benefit pension plans continue to be an important source of retirement security for 44 million American workers. But there has been a sharp deterioration in the funded status of pension plans, and the PBGC now has a record deficit as the result of the recent terminations of large underfunded plans.

When underfunded pension plans terminate, three groups can lose: participants can see their benefits reduced, other businesses can see their PBGC premiums go up, and ultimately Congress could call on taxpayers to support the PBGC.

Recently, the Administration issued our initial set of proposals to deal with the problem of pension underfunding. It has four parts:

- First, as the necessary initial step toward comprehensive reform of the funding rules, it improves the accuracy of pension liability measurement to reflect the time structure of each pension plan's benefit payments. This would be accomplished by measuring a plan's liabilities using a yield curve of highly–rated corporate bonds to calculate the present value of those future payments.
- Second, it requires better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding.
- Third, it provides new safeguards against underfunding by requiring financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. Similarly, it prohibits unfunded benefit increases by those severely underfunded plans sponsored by corporations with below investment- grade debt.
- And fourth, it calls for additional reforms to protect workers' retirement security by improving the funded status of defined benefit plans.

Treasury Under Secretary Peter Fisher and Labor Assistant Secretary Ann Combs testified on July 15 about these proposals. In my testimony today I would like to focus on plan underfunding, PBGC's financial condition, and the challenges facing the defined benefit system that need to be addressed with additional reforms.

As of December 31, 2000, total underfunding in the single-employer defined benefit system was less than $50 billion. Because of declining interest rates and equity values, as of December 31, 2002 – two years later -- the total underfunding in single-employer plans exceeded $400 billion, the largest number ever recorded. Even with recent rises in the stock market and interest rates, PBGC projects that underfunding still exceeds $350 billion today. (See Chart 1)

When the PBGC is forced to take over underfunded pension plans, the burden often falls heavily on workers and retirees. In some cases, participants lose benefits that were earned but not guaranteed by the pension insurance system. In all cases, workers lose the opportunity to earn additional benefits under the terminated pension plan.

PBGC's premium payers -- employers that sponsor defined benefit plans -- also pay a price when an underfunded plan terminates. Although PBGC is a government corporation, it is not backed by the full faith and credit of the U.S. government and receives no federal tax dollars. When PBGC takes over underfunded pension plans, financially healthy companies with better-funded pension plans end up making transfers to financially weak companies with chronically underfunded pension plans. If these transfers from strong to weak plans become too large, then over time strong companies with well-funded plans may elect to leave the system.

In the worst case, PBGC's deficit could grow so large that the size of the premium increase necessary to close the gap would be unacceptable to responsible premium payers. If this were to occur, Congress could call upon U.S. taxpayers to pick up the cost of underfunded pension plans through a Federal bailout of PBGC. In essence, all taxpayers would shoulder the burden of paying benefits to the 20 percent of private-sector workers who still enjoy the security of a defined benefit plan.

PBGC's Deteriorating Financial Condition

As a result of record pension underfunding and the failure of a number of plan sponsors in mature industries, PBGC's financial position has deteriorated sharply in the last two years. During FY 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion – a loss of $11.3 billion in just one year. The $11.3 billion loss is more than five times larger than any previous one-year loss in the agency's 28-year history. Moreover, based on our latest unaudited financial report, the deficit had grown to $5.7 billion as of July 31, 2003. (See Chart 2)

Because of this extraordinary one-year loss, the dramatic increase in pension underfunding, and the risk of additional large claims on the insurance program, the General Accounting Office (GAO) recently placed PBGC's single-employer program on its "high risk" list. In its report to Congress, GAO points to systemic problems in the private-sector defined benefit system that pose serious risks to PBGC. For example, the insured participant base continues to shift away from active workers, falling from 78% of all participants in 1980 to only 53% in 2000. In addition, GAO's report notes that the insurance risk pool has become concentrated in industries affected by global competition and the movement from an industrial to a knowledge-based economy. My hope is that GAO's "high risk" designation will spur reforms to better protect the stakeholders in the pension insurance system -- participants and premium payers.

Reasons for PBGC's Current Financial Condition

PBGC's record deficit has been caused by the failure of a significant number of highly underfunded plans of financially troubled and bankrupt companies. (See Chart 3) These include the plans of retailers Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including Bethlehem, LTV, National, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango; and airlines such as TWA. In addition, PBGC has taken over the failed US Airways pilots' plan. Mr. Chairman, pension claims against PBGC for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history -- $600 million for the Eastern Airlines plans and $800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the steel plans we have taken in lately: $1.3 billion for National Steel, $1.9 billion for LTV Steel, and $3.9 billion for Bethlehem Steel. Underfunding in the financially troubled airline sector is larger still, totaling $26 billion.

PBGC premiums have not kept pace with the growth in pension claims or in pension underfunding. (See Chart 4) Premium income, in 2002 dollars, has fallen every year since 1996, even though Congress lifted the cap on variable-rate premiums that year. The premium has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the dollar amount of a plan's underfunding, measured on a "current liability" basis. 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 Bethlehem Steel, the largest claim in the history of the PBGC, paid no variable-rate premium for five years prior to termination.

CHALLENGES FACING THE DEFINED BENEFIT PENSION SYSTEM

The funding of America's private pension plans has become a serious public policy issue. Recent financial market trends – falling interest rates and equity returns – have exposed underlying weaknesses in the pension system, weaknesses that must be corrected if that system is to remain viable in the long run. In addition to falling interest rates and equity returns, there are serious challenges facing the defined benefit system: substantial underfunding, adverse demographic trends, and weaknesses in the pension funding rules.

Concurrent Falling Interest Rates and Stock Market Returns

The unprecedented, concurrent drops in both equity values and interest rates have caused the unfunded liabilities of most defined benefit pension plans to increase dramatically over the last three years. (See Chart 5) Some argue that the current problems are cyclical and that they will disappear as the stock market recovers, but it is not reasonable to base pension funding on the expectation that the stock market gains of the 1990s will repeat themselves.

In order to understand how pension plans got so underfunded, it is important to consider how mismatching assets and liabilities affects pension plan funding levels. Pension plan liabilities tend to be bond-like in nature. For example, both the value of bonds and the value of pension liabilities have risen in recent years as interest rates fell. Were interest rates to rise, both the value of bonds and the value of pension liabilities would fall. The value of equity investments is more volatile than the value of bonds and less correlated with interest rates. Most companies prefer

equity investments because they have historically produced a higher rate of return than bonds. These companies are willing to accept the increased risk of equities and interest rate changes in exchange for expected lower pension costs over the long term. Similarly, labor unions support investing in equities because they believe it results in larger pensions for workers. Investing in equities rather than bonds shifts some of these risks to the PBGC.

Pension Underfunding

Pension liabilities represent financial obligations of plan sponsors to their workers and retirees. Thus, any pension underfunding is a matter of concern and may pose risks to plan participants and the PBGC. In ongoing, healthy companies, an increase in the amount of underfunding can affect how secure workers feel about their pension benefits, even though the actual risk of loss maybe low, at least in the near-term. Of immediate concern is chronic underfunding in companies with debt below investment-grade or otherwise financially troubled, where the risk of loss is much greater. Some of these financially troubled companies have pension underfunding significantly greater than their market capitalization.

As detailed in our most recent annual report, plans that are sponsored by financially weak companies had $35 billion in unfunded vested benefits. Of this $35 billion, about half represented underfunding in airline and steel plans. By the end of this fiscal year, the amount of underfunding in financially troubled companies could exceed $80 billion. As I previously noted, the Administration has already made specific legislative recommendations to limit the PBGC's growing exposure to such plans.

Demographic Trends

Demographic trends are another structural factor adversely affecting defined benefit plans. Many defined benefit plans are in our oldest and most capital intensive industries. These industries face growing pension and health care costs due to an increasing number of older and retired workers.

Retirees already outnumber active workers in some industries. (See Chart 6) In some of the plans we have trusteed in the steel industry, only one out of every eight pension participants was an active worker. The *Detroit Free Press* recently reported that pension, retiree health and other retiree benefits account for $631 of every Chrysler vehicle's cost, $734 per Ford vehicle, and $1,360 for every GM car or truck. In contrast, pension and retiree benefit costs per vehicle for the U.S. plants of Honda and Toyota are estimated to be $107 and $180 respectively. In a low-margin business, retiree costs can have a serious impact on a company's competitiveness.

Demographic trends have also made defined benefit plans more expensive. Americans are living longer in retirement as a result of earlier retirement and longer life spans. Today, an average male worker spends 18.1 years in retirement compared to 11.5 in 1950, an additional seven years of retirement that must be funded. (See Chart 7) Medical advances are expected to increase life spans even further in the coming years.

Weaknesses in the Funding Rules

When PBGC trustees underfunded plans, participants often complain that companies should be legally required to fund their pension plans. The fact is, current law is simply inadequate to fully protect the pensions of America's workers when their plans terminate. There are many weaknesses with the current funding rules. I would like to focus on six:

First, the funding targets are set too low. Employers can stop making contributions when the plan is funded at 90 percent of "current liability." The definition of current liability is a creature of past legislative compromises, and has no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants, premium payers and taxpayers.

Current liability assumes the employer will continue in business. As a result, it doesn't recognize the early retirements -- often with subsidized benefits -- that take place when an employer goes out of business and terminates the pension plan. Current liability also doesn't recognize the full cost of providing annuities as measured by group annuity prices in the private market. If the employer fails and the plan terminates, pension benefits are measured against termination liability, which reflects an employer's cost to settle pension obligations in the private market.

For example, in its last filing prior to termination, Bethlehem Steel reported that it was 84 percent funded on a current liability basis. At termination, however, the plan was only 45 percent funded on a termination basis -- with total underfunding of $4.3 billion. (See Chart 8) Similarly, in its last filing prior to termination, the US Airways pilots' plan reported that it was 94 percent funded on a current liability basis. At termination, however, it was only 33 percent funded on a termination basis -- with total underfunding of $2.5 billion. (See Chart 9) It is no wonder that the US Airways pilots were shocked to learn just how much of their promised benefits would be lost. In practice, a terminated plan's underfunded status can influence the actual benefit levels. Under the Administration's already-announced transparency proposal, participants would have been aware of the lower funding level on a termination basis.

Second, the funding rules often allow "contribution holidays" even for seriously underfunded plans. Bethlehem Steel, for example, made no cash contributions to its plan for three years prior to plan termination, and US Airways made no cash contributions to its pilots' plan for four years before the plan was terminated. When a company contributes more than the minimum required contribution, it builds up a "credit balance" for minimum funding. It 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 some or all of their value.

Third, 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. (See Chart 10)

Fourth, the minimum funding rules and the limits on maximum deductible contributions require companies to make pension contributions within a narrow range. Under these minimum and maximum limits, it is difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times.

Fifth, current liability does not include reasonable estimates of expected future lump sum payments. Liabilities must be calculated as if a plan will pay benefits only as annuities. Even if it is clear that most participants will choose lump sums, and that these lump sums may be more expensive for the plan than the comparable annuity, the minimum funding rules do not account for lump sums because they are not part of how current liability is calculated.

Sixth, because of the structure of the funding rules under ERISA and the Internal Revenue Code, defined benefit plan contributions can be extremely volatile. After years of the funding rules allowing companies to make little or no contributions, many companies are suddenly required to make contributions of hundreds of millions of dollars to their plans at a time when they are facing other economic pressures. Although the law's complicated funding rules were designed, in part, to minimize the volatility of funding contributions, the current rules clearly have failed to achieve this goal. Masking market conditions is neither a good nor a necessary way to avoid volatility in funding contributions.

PBGC Premiums

As I noted earlier, because PBGC is not backed by the full faith and credit of the federal government and receives no federal tax dollars, it is the premium payers -- employers that sponsor defined benefit plans -- who bear the cost when underfunded plans terminate. Well-funded plans represent the best solution for participants and premium payers. However, PBGC's premiums should be re-examined to see whether they can better reflect the risk posed by various plans to the pension system as a whole.

REFORMS NEEDED TO PROTECT THE DEFINED BENEFIT SYSTEM

Mr. Chairman, we must make fundamental changes in the funding rules that will put underfunded plans on a predictable, steady path to better funding. Improvements in the funding rules should set stronger funding targets, foster more consistent contributions, mitigate volatility, and increase flexibility for companies to fund up their plans in good economic times.

At the same time, we must not create any new disincentives for companies to maintain their pension plans. Pension insurance creates moral hazard, tempting management and labor at financially troubled companies to make promises that they cannot or will not fund. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and shutdown benefits may never be pre-funded. In exchange for smaller wage increases today, companies often offer more generous pension benefits tomorrow, knowing that if the company fails the plan will be handed over to the PBGC. This unfairly shifts the cost of unfunded pension promises to responsible companies and their workers. At some point, these financially strong companies may exit the defined benefit system, leaving only those companies that pose the greatest risk of claims.

In addition to the proposals the Administration has already introduced to accurately measure pension liabilities, improve pension disclosure, and protect against underfunding, the Departments of Labor, Treasury, and Commerce, and the PBGC are actively working on comprehensive reform. We are examining how to eliminate some of the risk shifting and moral hazard in the current system. We are crafting proposals to get pension plans better funded, especially those at risk of becoming unable to meet their benefit promises. And we are re-evaluating statutory amortization periods and actuarial assumptions regarding mortality, retirement, and the frequency and value of lump sum payments to ensure they are consistent with the goal of improved funding.

CONCLUSION

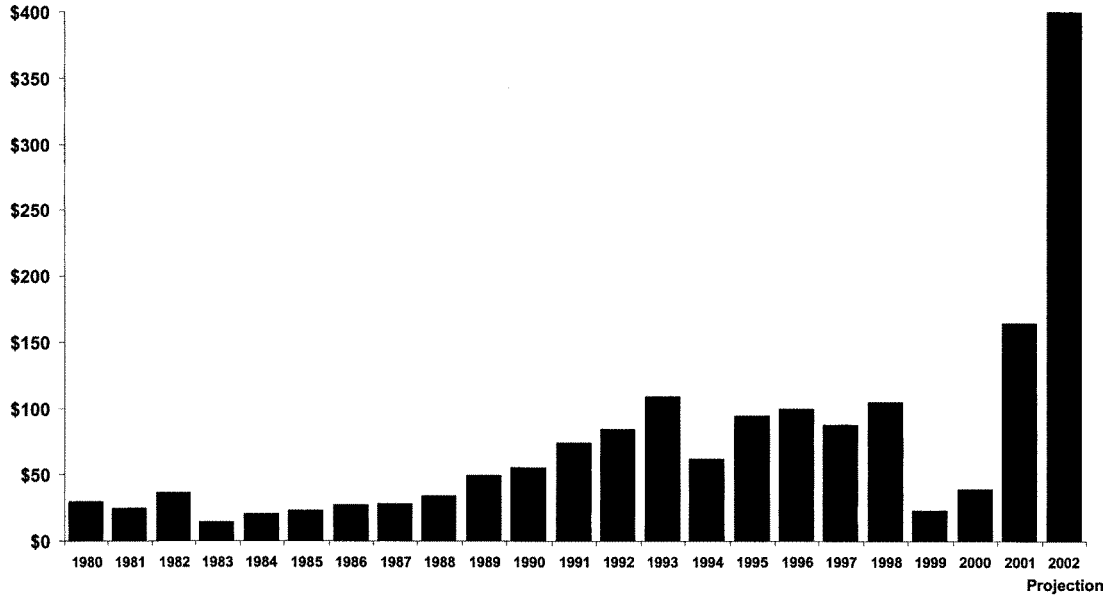
Mr. Chairman, we should not pass off the cost of today's pension problems to future generations. If companies do not fund the pension promises they make, someone else will have to pay -- either workers in the form of reduced benefits, other companies in the form of higher PBGC premiums, or taxpayers in the form of a PBGC bailout.

Thank you for inviting me to testify. I will be happy to answer any questions.

Total Underfunding

Chart 1

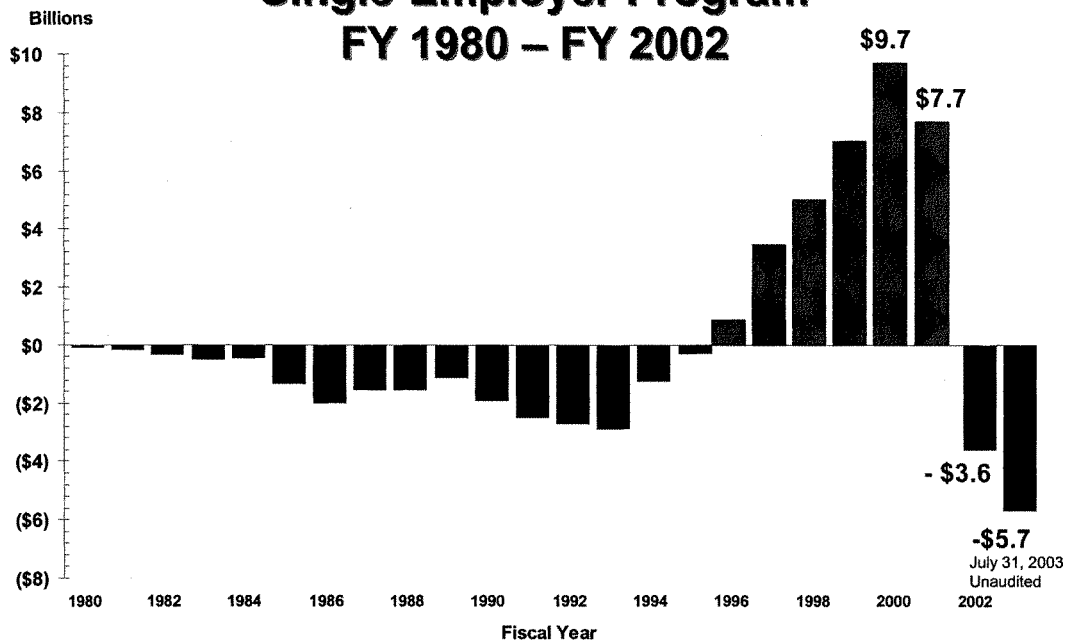
Insured Single-Employer Plans



PBGC estimates from Form 5500 and Section 4010 Filings

Chart 2

PBGC Net Position
Single-Employer Program
FY 1980 – FY 2002



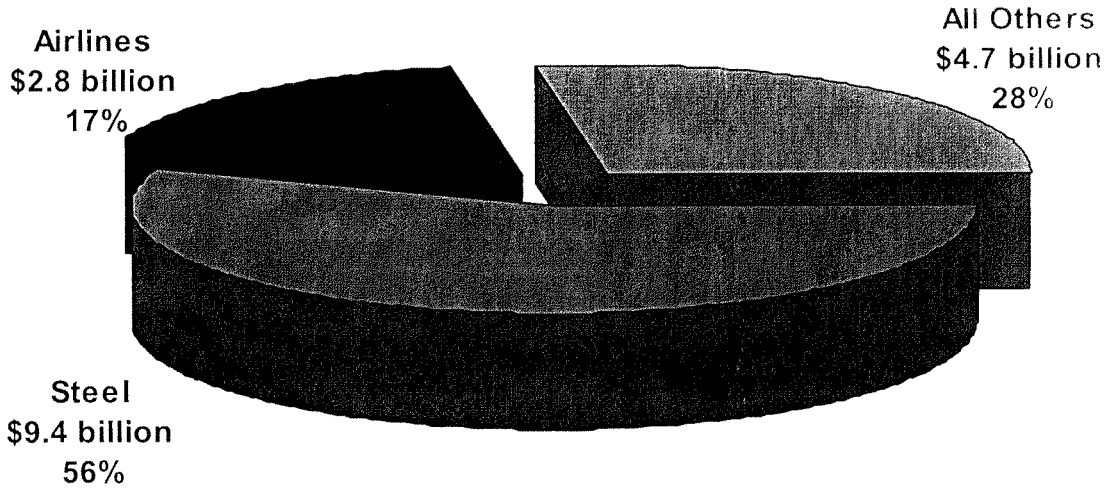
Data does not include restored LTV plans in 1986

Chart 3

Historic PBGC Claims

PBGC Claims FY 1975 - 2002

(including Bethlehem, National Steel and US Airways Pilots)

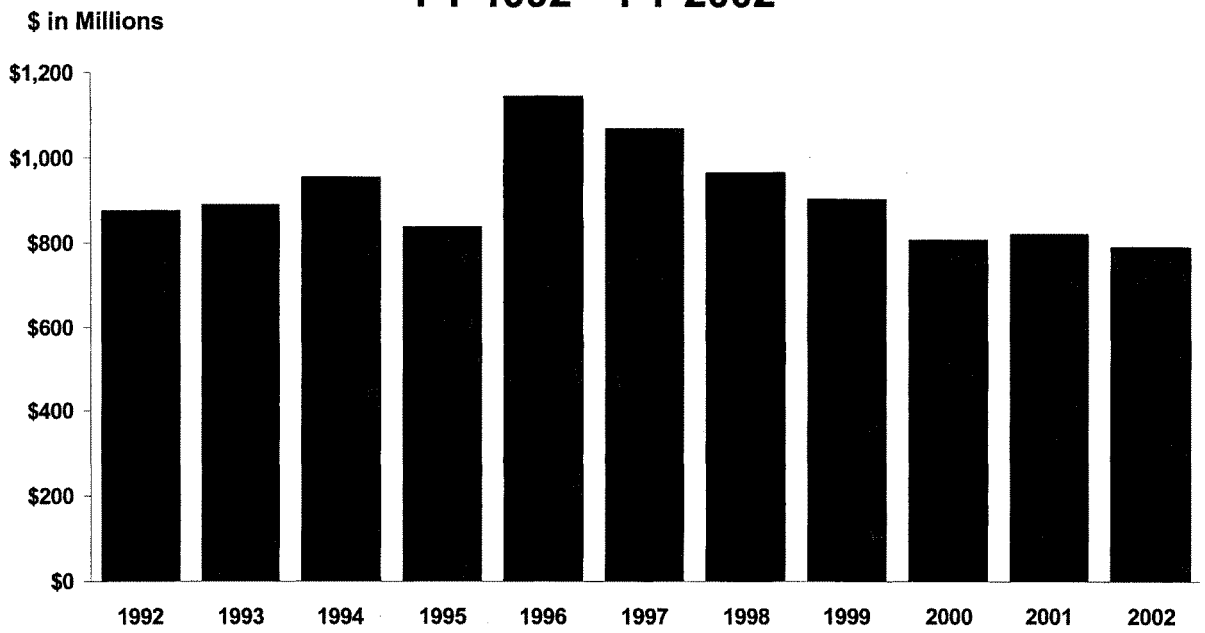


Note: Historically, Steel has represented less than 3% of participants covered by PBGC and Airlines less than 2%.

Chart 4

Single-Employer Premium Income

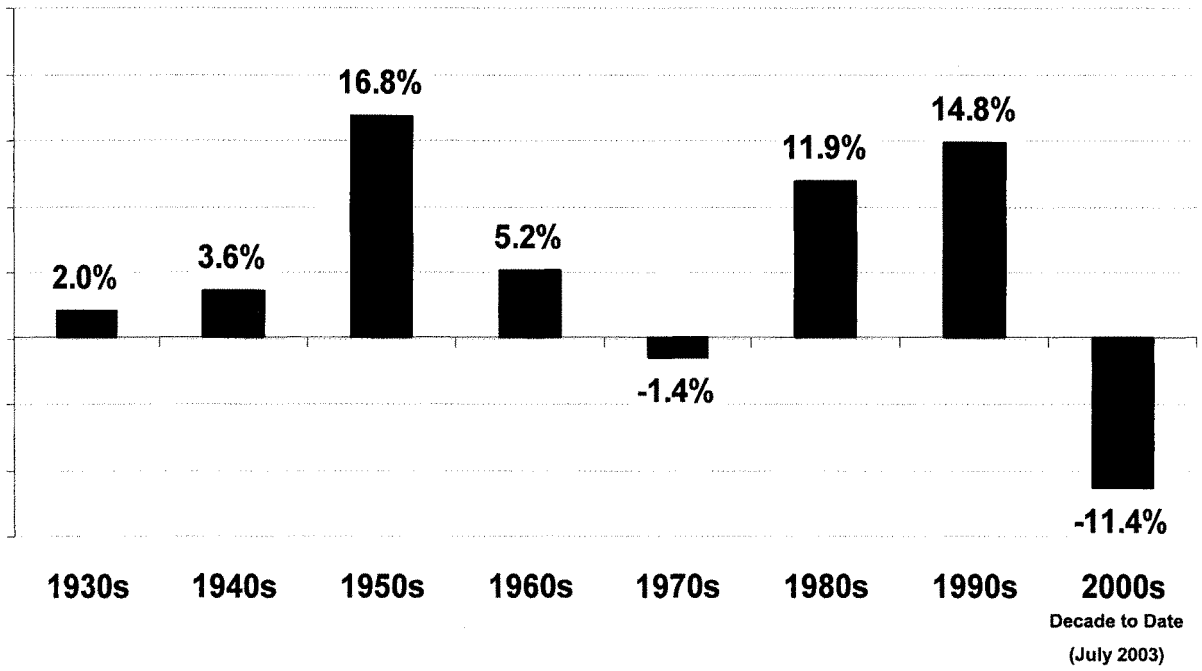
FY 1992 – FY 2002



NOTE: The variable rate premium was capped until 1996

Real Equity Returns

Chart 5

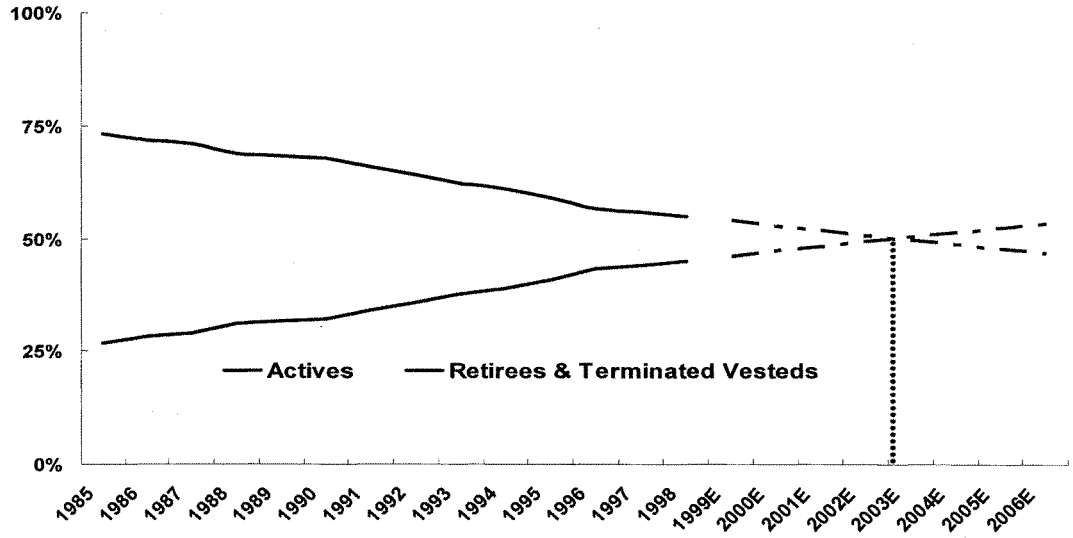


Source: Ibbotson Associates

Chart 6

Participants in Defined Benefit Pension Plans

[1985 - 2006$^{est.}$]



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1998 Form 5500 Annual Reports Winter 2001 - 2002

Chart 7

Average Number of Years Spent in Retirement

(Males)

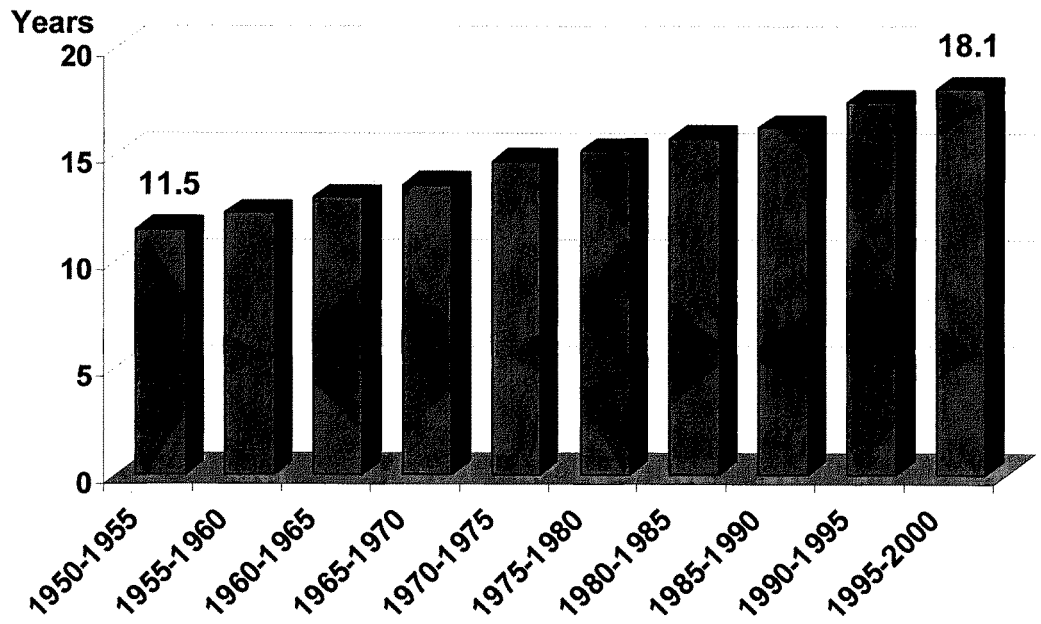


Chart 8

Bethlehem Steel

	1996	1997	1998	1999	2000	2001	2002
Current Liability	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

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

US Airways Pilots

Chart 9

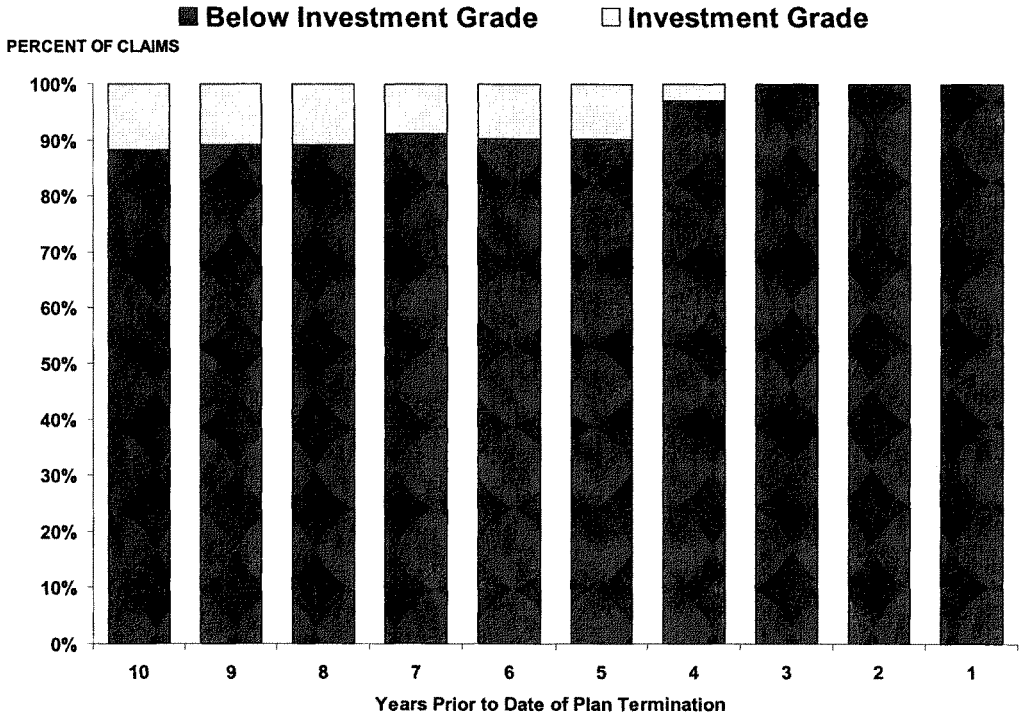
	1996	1997	1998	1999	2000	2001	2002
Current Liability	97%	100%	91%	85%	104%	94%	NR
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N	NR
Was the company obligated to send out a participant notice?	N	N	N	N	N	N	N
Did the company pay a variable rate premium?	$4 million	N	N	N	$2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

Termination Benefit Liability Funded Ratio 33%

Unfunded Benefit Liabilities $2.5 billion

Debt Ratings for Large Claims

Chart 10



NOTE: Based on 27 of PBGC's largest claims representing over 50% of all claims.

TESTIMONY OF
CHRISTOPHER W. O'FLINN
THE ERISA INDUSTRY COMMITTEE

BEFORE THE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET AND INTERNATIONAL SECURITY
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
MONDAY, SEPTEMBER 15, 2003

Safeguarding America's Retirement Security: An Examination of Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to present the views of The ERISA Industry Committee on the funding of defined benefit pension plans. I am Christopher W. O'Flinn, Vice President, Corporate Human Resources, AT&T Corporation and Chairman of The ERISA Industry Committee (ERIC), on whose behalf I am speaking today.

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.

All of ERIC's members sponsor 401(k) and other defined contribution plans. But we are unique in that almost all of the ERIC membership also sponsor defined benefit pension plans. Our members also pay the bulk of the premium-taxes collected by the Pension Benefit Guaranty Corporation (PBGC). Thus we have a very strong interest and concern in both in the vitality of the defined benefit system and in maintaining a strong PBGC. Time and again we have come forward with proposals for reform of the defined benefit system, frequently providing the basis on which the government could forge a consensus to resolve important issues. We work to understand this complex system and to try to share our perspective with thoughtful legislators like yourselves.

SUMMARY STATEMENT

The Subcommittee asked ERIC to address (1) the financial status of the Pension Benefit Guaranty Corporation, (2) the financial status of private sector defined benefit plans, and (3) specific proposals for reform aimed at either or both of the first two issues.

The defined benefit system is a voluntary system. No employer is required to sponsor a retirement plan. The Subcommittee's investigation is important and timely. If the public policy issues under consideration are not properly evaluated and resolved, the voluntary system will be undermined and millions of American workers will face retirement without a secure, defined pension benefit in their portfolio.

The Pension Benefit Guaranty Corporation (PBGC)

Is the PBGC in trouble?

The PBGC has issues that at some point should be addressed. For example, the current procedures regarding PBGC guarantees of shut down benefits have unsatisfactory results for both participants and for the PBGC. A review of the entire benefit guarantee structure also is in order, and we also are examining the PBGC proposals to expand current law provisions that stop severely underfunded plans from increasing benefits.

While the system can be improved, a close look indicates that the agency is not in trouble, however. The Subcommittee should monitor the financial status of the PBGC, but should recognize that the PBGC's funded ratio is higher than it has been for most of its existence. It appears readily able to weather the recent economic slowdown. Let me explain this point of view in more detail because it is important.

First, much has been made of the PBGC's current deficit, but the economic health of the PBGC is determined not by whether it has a surplus or deficit at any point in time but by its ability to pay benefits over a long duration to participants of plans it trustees. Moreover, the loss of the PBGC's surplus should not be a surprise in the current economic circumstances. It is, in itself, not a cause for alarm and can be expected to ameliorate as conditions improve.

In this regard, I want to make clear that ERIC supports a strong PBGC. Indeed we have everything to lose from a weakened or troubled PBGC since plan sponsors, not the taxpayer, will face higher premium taxes.

The truth is, PBGC has sufficient assets to pay benefits for the foreseeable future. In fact, the PBGC has operated successfully with a deficit for most of its history. Unfortunately, testimony by the PBGC before the House Education and Workforce Committee on September 4 overstates the challenges it faces. Not only does this make it difficult for Congress to respond appropriately, it discourages employers from establishing and maintaining defined benefit plans, undercutting PBGC's future premium base.

The Subcommittee should pursue several questions in order to attain a better understanding of the long term viability of the PBGC – questions to which we, too, would welcome answers. Based on the answers to these questions, Congress, the PBGC, and plan sponsors can proceed to devise appropriate responses. Specifically,

1) Rather than focusing on temporary deficits and surpluses, the Subcommittee should ask the PBGC to provide data and analysis regarding the program's funded

ratio (assets divided by liabilities) as well as its long term cash flow under various scenarios in order to determine whether the agency indeed has a short or a long term problem.

2) Since the PBGC does not purchase annuities, the Subcommittee should require and examine analyses of the PBGC liabilities using discount rates other than the PBGC-constructed annuity rate.

3) The Subcommittee should examine the impact of average claims over time on the agency rather than focus on periodic spikes in claims caused by temporary market conditions, especially since the PBGC neither pays lump sums nor purchases annuities.

4) The Subcommittee should work with the PBGC to develop a more consistent mechanism for including "probable" terminations – i.e, terminations that have not yet actually occurred – in its surplus and deficit calculations. And it should work with the PBGC to ensure that information regarding "possible" future terminations is developed on a sound basis and is presented in a way that it will not be confused with actual or probable claims.

The PBGC may well face issues that should be addressed, but there is ample time and resources to address them. A short-sighted focus on swings in PBGC's surplus and deficit merely drives premium payors away from the defined benefit system – which is what is happening now.

The real security of the PBGC lies not in imposing new rules that force cash-strapped companies to choose between growth or even survival and putting more money into their pension plans. It lies in fostering a vibrant system with lots of companies maintaining defined benefit plans on which they pay premium taxes to the PBGC.

The Status of Private Sector Defined Benefit Plans

The primary crisis facing private sector defined benefit plans is not a snapshot picture of their funded status at the end of a difficult economic downturn -- the issue that has received the most attention in the press. The primary crisis facing defined benefit plans and the employers who voluntarily sponsor those plans is the failure to date of the government to enact a replacement for the defunct 30-year Treasury bond for pension regulation, especially the use of the 30-year bond as the discount rate mandated to calculate a pension plan's current liability.

Replacement of the defunct 30-year bond is not "relief." It does not relieve a plan from its legitimate funding obligations. Underfunded plans will still be required to speed up cash contributions to their funds. Replacement of the 30-year bond rate simply places funding requirements on a rational standard.

Why is action on this issue so urgent? Why isn't December, or sometime next year, time enough to act?

The lack of a permanent and rational discount rate in the law subjects plan sponsors to enormous unnecessary cash calls and debilitating uncertainty. Companies are today implementing their 2004 budgets and determining their likely business plans for 2005 and beyond. Business and financial planning does not occur in a vacuum nor is it established in a last-minute, crisis mode. Companies cannot afford to assume what Congress might do at some point in the future. They are instead delaying business expansion, moving jobs off shore or eliminating them, or even going into debt to secure their operating cash. Credit raters and stock analysts are today examining companies' future cash flows. They want to know whether the company can withstand the enormous cash calls that will hit companies if Congress does not act. They are looking at projections three, four, and five years into the future based on the defunct 30-year rate. Stock prices and credit ratings have decreased based on those projections.

No business can tolerate this type of irrationality for long. Icon U.S. companies, some of whom have sponsored defined benefit plans for fifty years or longer, are re-examining their commitment to the defined benefit system. I am aware of some that already have frozen their defined benefit plans to new entrants.

In this environment, the government has an overwhelming obligation to enact – now – the widely-accepted composite corporate bond rate as a replacement for the 30-year bond. Then it can turn its attention to the need to rebuild our defined benefit system.

Regarding the funded status of the defined benefit system, while year-end 2002 reports indicated a higher level of underfunding than the previous year, this is primarily a result of decreases in interest rates. Up-to-date 2003 reports indicate the funding dip already is being reversed. What this tells us is that the so-called funding crisis is instead a cyclical phenomenon that is very likely to correct itself. It should be monitored and examined, but it is not a cause for drum beating or the formulation of major new public policy.

Proposals for Reform

If defined benefit plans are to be a vital component of retirement income security for American workers and their families in the future, the government must act in a thoughtful and helpful manner to create an environment that encourages rather than discourages responsible participation by employers in the retirement system. ERIC proposes that proposals for reform be tested against the following principles:

1) REPLACING THE 30-YEAR BOND. The most important single action the government can take is immediately to enact legislation that replaces the defunct 30-year Treasury bond with a composite of high quality, long term corporate bond indices for purposes of pension regulation.

2) VOLUNTARY SYSTEM. The U.S. pension system is voluntary. Employers are not required to offer employees a retirement plan. To create a robust system, more than neutrality is required from the government. The government must

make it clear to employers that it supports them when they offer retirement plans – including defined benefit plans – to their employees.

3) COORDINATION. ERISA is a reticulated statute. It is critically important that reforms not be enacted in a piecemeal basis. This especially applies to the Administration's proposals to change the structure of liability calculations to incorporate duration-adjusted discount rates and its proposals to add additional disclosure requirements on top of the existing confusing scheme.

4) LONG TERM COMMITMENT. Pensions are both funded and dispersed over a long period of time. While short term, or spot measures such as the yield curve proposed by the Administration may produce a more precise point-in-time estimate of plan liabilities than is obtained under current law, it is not at all clear that such measures produce a more accurate measure of the plan's ability to meet its obligations over time. Spot measures of pension liability and funding requirements based on such measures can result in volatile cash calls on the company while the goal of future reforms should be instead to reduce the volatility of funding requirements. In addition, we note that it makes no sense to describe the funded status of an ongoing plan in terms of its "termination liability," as has also been proposed by the Administration. Publishing such calculations will lead people to believe that plans will terminate when they are not terminating. After a period of time, when the plan doesn't terminate, people will discount this information, as well as important information provided elsewhere.

5) CHANGING WORKFORCE. Even in plans with a preponderance of retirees, benefit payout typically is a long-term commitment – over ten to twenty years or longer. Thus proposals to impose different (duration adjusted) measures of liability on plans with a preponderance of retirees may unnecessarily impose additional burdens on those plans. To address the modern pension system effectively, the government should instead focus on providing much-needed regulatory certainty for innovative hybrid defined benefit plan designs created to meet the profile of today's more mobile workforce.

6) DISCLOSURE. Disclosure rules should be considered separately from funding requirements. Disclosure should provide the employer, participants, and the investment community relevant, helpful, and timely information concerning the long-term viability of the company's pension plan. Recent Administration disclosure proposals, which rely on harsh and unrealistic measures, appear instead to be designed to force companies to speed up contributions to plans far beyond what is necessary to meet liabilities over time in the future. This causes several adverse repercussions: scarce employer cash is diverted (typically at the bottom of a business cycle), investors are discouraged from investing in companies that offer defined benefit plans, employers are discouraged from maintaining a defined benefit plan at all, and, as a result, the PBGC's premium base is further weakened and concerns about the long term health and vitality of the retirement system are aggravated.

7) REWRITE V. AMENDMENT. Unlike the situation in 1987, there is no current need for a major overhaul of the pension funding rules. In 1987 ERIC recommended the creation of special funding rules to speed up the flow of cash to severely underfunded plans. Today, in general, the current-law two-tier funding system works well. In evaluating the progress since 1987, it is important to remember that many of the plans currently being assumed by the PBGC were accorded special transition arrangements in the law then and in the 1994 amendments. These plans were not subject to the more rigorous funding rules for the entire period since 1987. At the same time, the funded status of plans that the PBGC is assuming has improved. Prior to 2001, 41.3% of PBGC claims arose from plans less than 25% funded at termination. In 2002, PBGC indicated that the cumulative percentage of claims terminating less than 25% funded had declined to less than 30% of claims. (see Table S-13, PBGC's "Pension Insurance Data Book" for 2001 and 2002). Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform. It does not. Some modifications could be considered to improve the current rules to increase the attractiveness of defined benefit plans to employers.

8) FLEXIBILITY. Current law disincentives to funding should be removed. Current law restricts deductions for funding and the timing of contributions. It imposes excise taxes if a company funds up its plan over set limits. Future rules should provide additional flexibility regarding the ability of an employer to fund the pension plan whenever the company has extra cash, should provide full deductibility of contributions made, and should eliminate excise taxes on contributions to plans.

9) BENEFIT GUARANTEES. Current law provides different rules for plans that are fully funded and for plans that are less than fully funded. There has been no similar examination of what guarantees should apply to plans terminated with insufficient funds. It would be appropriate to reconsider an appropriate guarantee scheme based on our over 25 years of experience with the current system.

OVERVIEW OF THE DEFINED BENEFIT SYSTEM

Define benefit pension plans are an essential part of retirement income security for approximately 42 million U.S. workers and their families. Under typical defined benefit plans –

- Participation is automatic; employees do not have to make an election or reduce their wages in order to accumulate retirement savings.

- Unlike defined contribution plans, the employer shoulders the investment risk; and, for most participants, benefit amounts are fully guaranteed by the Pension Benefit Guaranty Corporation.

- Benefits under a defined benefit plan can be adjusted to reflect changing economic circumstances or business needs more efficiently than under a defined contribution plan. For example, under a defined benefit plan an employer can provide full benefits to employees prior to the normal retirement age through "window" plans; or an employer can provide past service credits as part of a benefit increase.

- Plans must offer an annuity payout, ensuring that retirees do not outlive their savings and providing critical survivor protections.

- The reliability of payments from a defined benefit plan reduces pressure on government programs such as social security.

- The over $1.6 Trillion held in defined benefit pension trusts is an important source of long-term investment in the nation's economy.

Whether defined benefit plans continue to be available on a wide-spread basis in the future, however, is an open question. While the workforce has grown, the number of participants in defined benefit plans has remained relatively constant and the number of plans offered has dropped dramatically. The number of plans insured by the PBGC has dropped from 112,000 in 1985 to 30,600 in 2002.

- Beginning in the early 1980's layer upon layer of burdensome regulation, often overlapping and sometimes contradictory, were heaped upon defined benefit plans. This trend was only recently reversed in bipartisan pension reform bills, but the task of imposing only necessary, rational, and workable rules on defined benefit plans is far from done.

- Government regulation prevents a company from putting extra funds in its plans during favorable economic times and imposes harsh funding requirements during economic downturns. It over-relies on mandated and point-in-time measures of liability that result in volatile funding requirements that are unworkable and unacceptable in a business environment.

- Government regulation has failed to support innovation in defined benefit plan design. For example, while hybrid plan designs have been in existence since the mid-1980s, the government only now is attempting to provide an appropriate regulatory framework for these plans, which have enabled employers to extend meaningful benefits to American workers throughout their careers and regardless of their career choices. The absence of guidance has inhibited expansion of pension coverage, caused confusion among the courts, exposed plan sponsors to unnecessary litigation, disruption, and adverse publicity, and created uncertainty among plan sponsors and participants.

- The United States is lurching toward the retirement of the largest demographic group in its history with no national retirement policy in place. Reforms are proposed and enacted (and thereafter often changed) piecemeal, with no

consideration or knowledge of their impact on the long term retirement security of its citizens.

Today, defined benefit plans are under unprecedented pressures: volatile and harsh contribution requirements triggered by a unique economic cycle and an inappropriate statutory standard, a barrage of unfavorable press reports, and widespread exposure to litigation paired at least in part with an absence of regulatory clarity in key areas. These pressures clearly discourage employers who want to provide a retirement plan for their employees from adopting or retaining a defined benefit plan.

What the government does in the coming weeks will tip the balance one way or the other – toward a vibrant retirement system offering individuals both defined benefit and defined contribution options or toward a more narrow system that relies almost entirely on plans where the employee bears the investment risk and that saddles the nation with reduced amounts of secure retirement income for future retirees and increased pressure on government programs.

In short, the health and vitality of the nation's private retirement system and accordingly the retirement security of millions of American workers is at stake in the current debate and analysis over funding and other reforms.

HOW THE SUBCOMMITTEE SHOULD ADDRESS ISSUES FACING THE PENSION BENEFIT GUARANTY CORPORATION

What is the PBGC?

One of the primary aspects of a defined benefit plan that makes it attractive to employers and employees alike is its stability. Employees count on the fact that benefits they have earned to date will not be reduced by amendment or fortune. Even if a plan sponsor goes bankrupt and leaves an underfunded plan behind, employees' pensions, up to certain guarantee levels, are protected and paid by the Pension Benefit Guaranty Corporation (PBGC).

The PBGC operates like a very large pension plan – not like an insurance company. When it trustees a plan, it assumes management of the assets of the plan's pension trust and it pays benefits directly to participants from the accumulated assets of the plans that it trustees, much like a large, ongoing pension plan. It does not purchase annuities from insurance companies. It invests and earns money on the assets it holds. In addition, all of the PBGC's obligations are paid out over decades because it does not pay out lump sum benefits.

An insurance company has only one chance to collect money to fund annuities it pays as well as to secure its own profits – the point in time when the purchaser buys the annuity. The PBGC has additional sources of revenue. It seeks additional funds from the companies of plans it trustees. It also collects about $800 million a year in premium tax

revenue from defined benefit plan sponsors. In addition, the PBGC does not need to make a profit and has greater latitude than an insurance company to invest in equities.

The PBGC also has authority to borrow money from the U.S. Treasury. However, this is a very unlikely occurrence. If the PBGC needs more money, the most likely occurrence will be a hike in the PBGC premium tax paid by my company and other sponsors of defined benefit plans.

What is the PBGC's financial status?

The current financial status of the Pension Benefit Guaranty Corporation (PBGC) should be monitored by Congress, but does not require any action this year. The PBGC's funded ratio still is stronger than it has been for most of its history, and the corporation is abundantly able to pay promised benefits to participants in plans it trustees for the foreseeable future.

Reports that the PBGC "could be the next S&L crisis" are irresponsible and harmful to the defined benefit system. First, unlike with an S&L, there can be no "run on the bank" in plans maintained by the PBGC. Individuals can collect benefits from the PBGC only after they meet the eligibility criteria and then only as annuities paid out over time. Second, even if the PBGC were to trustee several large additional plans, they would still be able to pay benefits for a very long time. This is because they receive the assets of the plans up front – but pay benefits only over decades. Thus, even if the current deficit of the PBGC were to further spike it would be on top of a much higher asset base.

The health of the PBGC is determined not by a short-term surplus or deficit but by its ability to pay benefits over the long haul. The loss of the PBGC's surplus should not be a surprise in the current economic circumstances and is, in itself, not a cause for alarm. Indeed, given the requirement of ERISA (Sec. 4002) that the PBGC "maintain premiums established by the corporation…at the lowest level consistent with carrying out its obligations under this title," maintaining a surplus might be in violation of the corporation's charter.

Current analysis, which tends to be very short sighted, does not tell us enough to answer the question of the PBGC's long term viability with confidence. The health of the PBGC should not be judged by its funded status at a point in time using spot interest rates. The Social Security system, for example, examines its ability to pay benefits for 75 years into the future. While we are not recommending a 75-year projection for the PBGC, there are several things that could be done to help this Subcommittee, the Congress, and us, the premium payers, gain a better understanding of the actual status of the PGBC.

On what should the Subcommittee focus?

First, several statements recently made by the PBGC should be clarified.

- The corporation's September 4 testimony before the House Education and Workforce Committee fails adequately to take into account recent improvements

in the economy. The testimony retains an estimate of total underfunding in the single-employer DB system of $400 billion as of 2002 – and fails to acknowledge, as have several other studies, improvements in estimates of the funded status of plans that have occurred throughout this year. Failure to update this estimate obscures the cyclical nature of the current situation and provides an unrealistic base from which to analyze the PBGC going forward.

- A similar problem occurs relative to the PBGC's July 31, 2003 uptick in the estimate of its deficit to $5.7 billion. Since the interest rate the PBGC uses lags the economy by six to ten weeks, this number fails to take into account recent dramatic changes in interest rates. In addition, as discussed below, the interest rate used by the PBGC leads to inflated liability numbers.

- In addition, while the PBGC reports an uptick in its deficit, it does not supply information regarding its funded ratio. Even after the assumption of the Bethlehem Steel plan, the PBGC had a funded ratio of approximately 90%, which is better than its first 20 years and would mean, under the ERISA funding rules, that the program was very well funded indeed for this point in an economic cycle. ERIC has asked for information regarding the PBGC's assets that would enable us to compute a current funded ratio for the PBGC, but the PBGC has failed to supply us that information. Perhaps they will supply it to the Subcommittee.

- In detailing challenges facing the PBGC, the September 4 testimony (at page 6) states that because of improvements in male longevity since 1950, plans face "an additional seven years of retirement that must be funded." The implication that there are seven years of benefit payments that are not funded is incorrect. Employers already fund plans using modern mortality tables approved by the Treasury Department. While some mortality improvements will occur in the future, there is no hidden liability that is being shifted to the PBGC.

- Finally, as explained in more detail below, the PBGC should provide more information on its funded ratio; use a more realistic discount rate; analyze claims in terms of averages over time rather than focusing on temporary and cyclical spikes; and take much greater care to distinguish between actual claims, probable claims, and possible claims so that the Congress and the public do not confuse what are in fact different numbers.

<u>The Subcommittee should require that the following steps be taken in order to adequately assess the financial health of the PBGC and in order to ensure that the financial statements of the PBGC provide the best possible information to the Congress and the public:</u>

1) FUNDED RATIOS AND LONG TERM CASH FLOW. In presenting its financials, the PBGC should place greater emphasis on its long-term ability to pay benefits than on short-term measures of surplus or deficit. Despite the events of the last few years, the PBGC can pay benefits for many years into the future. In fact, based on its 2002 report adjusted for the subsequent termination of the Bethlehem Steel plan, if the

PBGC were to receive no additional income whatsoever, it could easily maintain the current level of benefit payments for more than 10 years. With asset and premium income, that period will be longer. The PBGC has over $30 billion in its trust funds – assets acquired from plans it has trusteed as well as from premium payments. The agency has done well with its assets, earning an average of 12% a year from 1985 through 2002. As noted above, the agency had a funded ratio of 90% post-Bethlehem.

Rather than focusing on the PBGC's current surplus or deficit – which fluctuates dramatically with the economy and interest rates – the Subcommittee should ask the corporation for analyses of the program's funded ratio (assets divided by liabilities) as well as long term cash flows under various scenarios, in order to determine when the agency indeed has either a short or a long term problem or, in fact, any problem at all.

2) REALISTIC DISCOUNT RATE. The PBGC should use a more realistic discount rate in calculating its liabilities. Currently the PBGC calculates its liabilities based on a non-competitive annuity purchase rate compiled through an undisclosed basis from information provided by the insurance industry. However, the PBGC does not purchase annuities; it pays benefits from its assets much like a large pension fund. It also invests those assets and over the long term has reaped significant benefit, as do pension funds, from an equity premium.

While use of a conservative rate may be appropriate for a quasi-federal agency such as the PBGC, over-conservatism has severe costs. Overstating plan liabilities is directly harmful to participants, plan sponsors, and the entire retirement system. It results in participants losing their non-guaranteed benefits. It results in excessive premiums being charged to plan sponsors. It also fails to provide an accurate picture to the Congress of the corporation's financial health. The Subcommittee should examine the liabilities of the PBGC based on realistic rates appropriate for an ongoing enterprise rather than the PBGC-constructed annuity rate.

3) AVERAGE CLAIMS OVER TIME. In presenting information on claims, the PBGC should place greater emphasis on average claims over a period of time. The PBGC claims experience is characterized by sharp spikes that are cyclical in nature and directly relevant to temporary market conditions. Claims spikes occurred in 1987, 1991-1992, 2001-2002, and to a lesser degree in 1994. For all other years, claims were quite modest. It makes no sense to assume that the agency's experience for 2001-2002 reflects its future. This has never been the case. The Subcommittee should seek information on the experience over time of actual claims presented to the PBGC.

4) CONSISTENT & TRANSPARENT MECHANISMS FOR "PROBABLE" AND "POSSIBLE" CLAIMS. The agency should develop more consistent and transparent mechanisms for including "probable" terminations in its surplus/deficit calculations as well as for announcing "possible terminations." The PBGC reports three kinds of claims – actual claims that have been presented to the corporation; "probable" claims that it expects to receive in the near future; and "possible" claims that it might receive over the next several years. The differences are substantial and important. For example, for FY 2002, although the PBGC reported an $11.3 billion swing in is surplus/deficit position,

$6.3 billion, or over half, is attributable to "probable" claims that did not, in fact, occur during FY 2002. Put another way, gross liabilities from probable terminations can be 20% to 30% of PBGC's total liabilities. The corporation's 2002 report (at page 40) indicates that it eventually trusteed 78% of plans reported as probable terminations between 1987 and 2001. This means it did not incur claims for 20% of probables during that time.

The criteria for the PBGC "probables' is not apparent. We question whether it is appropriate for the PBGC to report claims that are not yet incurred using an undisclosed basis. We believe the PBGC should publicly state its criteria and that the Subcommittee should seek additional information in this area. In this regard, we note that the PBGC's inspector general stated "PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable plan terminations." (FY 2002 report, at page 48).

The mechanism for producing "possible" claims also is not a transparent one. The PBGC's 2002 report (at page 41) reports $35 billion of additional liability from terminations that might occur sometime in the future, a number bumped up to $80 billion in the PBGC's September 4 testimony.

There are both public information and policy concerns with these reports. Without clear criteria regarding how these numbers are produced and what they mean, it is far too easy for the public to assume that all $80 billion in new claims will occur and occur soon – just added onto the currently projected deficit. Indeed that is exactly what occurred in the next-day press reports. It does neither the PBGC nor the defined benefit system good to highlight large, easily misunderstood, and ill-defined numbers in public statements.

On a policy level, the data used to produce these numbers appears to be taken from the trough of the recent downturn, not reflecting recent upticks. In addition, it is unclear the mechanism by which these numbers are produced and whether these figures were subject to a reality adjustment. In other words, if at a particular point in time there is a net unfunded liability of $80 billion in companies with junk bond status, it does not mean that the corporation is likely to receive claims for all of these amounts. Were considerations such as this taken into account? It is not clear.

While we agree and believe that the PBGC should have some way of reporting reasonably expected claims, it appears that under the current undisclosed system there is considerable leeway in determining what year in which to include those expected claims as well as the criteria by which to select claims.

The Subcommittee should work with the PBGC and other experts to develop a more consistent method for the PBGC to provide information regarding probable terminations that have not yet occurred and that, historically, did not occur in 20% of the cases as well as a range of possible future scenarios.

What about PBGC proposals to cut off benefit increases?

The PBGC may face spikes in liabilities because of mis-matches between current law funding and guarantee rules. For example, the corporation has terminated plans in order to avoid being liable for unfunded shut-down benefits. Another approach may prove more satisfactory for both participants and the PBGC.

Other factors may also cause spikes in the corporation's liability in a terminating plan. We believe it is appropriate to work together to get a better understanding of such circumstances and to formulate rational policies to deal with them. For example, current law forbids enactment of a benefit increase in a plan less than 60% funded unless money or security is provided to restore the plan to a funded level of at least 60%. The PBGC has proposed additional such measures. Such measures should be evaluated against the following criteria: (1) The proposal should protect participants rather than merely shield the PBGC from additional liability. (2) The proposal should target actions that drive down a plan's funded status; it should not affect the normal operation of the plan. (3) The impact of the proposal should be predictable. A proposal to cease normal benefit accruals when a plan's funded status falls below an arbitrary level fails all three of these criteria.

Conclusion

The best security for the PBGC is a robust defined benefit system. While we have concerns about the PBGC's evaluation of its own condition as well as about some of its reform proposals, we are very supportive of the overall mission and management of the PBGC and would be pleased to work with it and the Subcommittee in evaluating and clarifying the issues we have discussed. In the meantime, it is critical to keep the primary focus today on responding to the very real and immediate crisis facing plan sponsors – replacement of the defunct 30-year bond.

ERISA'S FUNDING RULES AND WHAT SHOULD BE DONE ABOUT THEM

Introduction

The regulatory burden on defined benefit plans increased due to a seemingly endless stream of legislative restrictions enacted from 1982 through 1994, typically as part of deficit reduction measures enacted by Congress. Among other important matters, the amendments enacted between 1982 and 1994 severely curtailed the ability of companies to make tax deductible contributions to their pension plans, a fact that is important for today's discussion.

In addition, in 1987, and again in 1994, the government imposed an additional, back-up set of funding obligations on plans that were considered to be either severely or persistently underfunded on a current liability basis. A plan that becomes subject to the special current liability funding rules no longer enjoys the long-term perspective of ERISA's basic funding rules. Instead, it faces a sharp increase in cash contributions designed to reduce the plan's deficit by 20-30% per year. In determining the funded status of a plan for the purpose of these special funding rules, the government requires

use of a four-year weighted average of the 30-year Treasury bond rate and imposes a required mortality assumption.

Under these rules, plan sponsors today are caught in a squeeze play: In good times they are unable to advance fund their plans to prepare for cyclical economic downturns; and they must rapidly fund up when those downturns occur and when they can least afford it. The result is perverse and is a major factor in undermining the health and vitality of the retirement system.

Today's economic climate along with the perverse funding rules is further undercutting the attractiveness of defined benefit plans for employers. The current liability funding rules were never intended to apply to the majority of plans – but under the combined impact of reduced asset returns and lower interest rates, that is what is happening today.

Sadly, this flawed pension funding process has become a counterweight to U.S. fiscal policy. Every time the government lowers the rates to stimulate the economy, companies must rethink their future pension funding requirements. Funds that might previously have been earmarked for capital improvements and jobs growth, must now be set aside to provide for escalating pension funding requirements. In effect, the ability of companies to invest in the future of our economy is being held hostage by the very government actions intended to stimulate such growth.

Although the evidence is anecdotal, an increasing number of employers facing unrealistic cash calls under the pension funding rules are today freezing their plans for either new or current participants. Employers who are still maintaining their plans are not extending them to employees acquired during a business transaction.

The 30-year Treasury bond

When, in the late 1990's, the federal government began to buy back outstanding 30-year Treasury bonds from the open market, supply and demand factors forced the spread between a corporate rate and the 30-year Treasury rate required for pension funding calculations to widen. This situation worsened in 2001 when the U.S. Treasury ceased to issue new 30-year Treasury bonds. As a result, plan sponsors are left with a meaningless interest rate that artificially increases the calculation of pension liabilities and that fails to reflect any rational basis with which to regulate pension plan funding.

The inappropriateness of relying on the 30-year bond as a benchmark has been generally recognized since the late 1990's when the government began to buy back these bonds, causing their rate to drop substantially relative to historical levels and relative to other benchmarks. In late 2001, the bond was discontinued entirely. In early 2002, Congress recognized the problem by enacting a temporary higher rate that can be used by pension plans for 2002 and 2003. In August 2002, ERIC proposed a composite rate of high quality, long-term corporate bond indices as a permanent replacement for the 30-year rate. The framework of this proposal has been endorsed by the entire business community as well as the AFL-CIO, included in legislation introduced by Sen. Judd Gregg (S.1550) and Reps. Rob Portman and Ben Cardin (H.R.1776), approved by the

Ways and Means Committee for 2004-2006, and recommended by the Administration for use in 2004 and 2005. But all of this is for naught if Congress fails swiftly to bring this solution to the President's desk to be signed into law.

Prompt action to replace the defunct 30-year Treasury bond rate for purposes of regulating pension plans is critical to protect the retirement security of millions of American workers and to avoid undercutting the ability of many companies to fuel national economic recovery

The solution

There has been a general recognition that a high quality, long-term corporate bond rate provides an appropriate and reasonable measure of pension obligations.

ERIC urges you to recommend that the government replace the 30-year Treasury rate with a composite rate of high-quality, long-term corporate bond indices that would be selected through Treasury regulations. ERIC also proposes to

- Coordinate the new rate with related mortality assumptions;
- Phase in the new rate for lump sum calculations; and
- Reduce the frequency with which employers bounce in and out of the current liability funding and quarterly contribution requirements.

A composite corporate bond rate corresponds to the rationale Congress outlined when it established the current liability funding rules in 1987. It reflects the returns on an insurance company portfolio that funds group annuities. The proposed composite rate is higher than today's 30-year Treasury rate. But this is appropriate because the current use of the Treasury rate overstates the minimum funding needed to assure retirement security for plan participants.

Moreover, other possible replacements for the 30-year Treasury rate do not provide the combination of simplicity, transparency, relevance, immunity from manipulation, and availability provided by a composite corporate bond rate.

What happens if the 30-year Treasury rate is not promptly replaced?

Companies today are preparing to implement their 2004 budgets. If Congress fails to act, 2004 current liability calculations will be dictated by a maximum rate of 105% of the four-year weighted average of (the defunct) 30-year Treasury bonds. Projecting the July 2003 through the end of the year, this would mean that plans would be forced to calculate their current liabilities with a maximum interest rate of 5.47% compared to 6.83% under the ERIC proposal. If this were to occur–

- Current liability calculations would increase by 15% or more.

- Many additional companies, including companies with plans that are in fact well-funded, must assume they are subject to the special funding rules. Both they and those already subject to the rules will experience a spike in their contribution

requirements. This will unnecessarily divert money that otherwise would have been spent to build new plants, buy equipment, pay for research and development, and support jobs.

- Plans that become subject to the current liability funding rules also must notify employees of their underfunded status (even if the plan is not underfunded using reasonable measures), and must pay variable rate premiums to the PBGC. Business operations of these plan sponsors also come under increased scrutiny by the PBGC.

- Companies will suffer reduced credit rankings and diminished stock values.

There is no economic justification for these consequences. Thus, it is apparent that affected companies will find their support for defined benefit plans diminished. A strong financial incentive will be created to limit future liabilities. Where cash is in short supply, companies will have no option but to freeze their plans.

There is additional fall-out just from the uncertainty companies currently face. CEOs and CFOs need to know now whether they will be able over the next several years to purchase new plant and equipment, to invest in research and development, and to accomplish other vital business objectives.

Consequences of the funding squeeze, caused in part by the continued reliance on the 30-year Treasury rate, already are occurring. A recent survey by Deloitte & Touche indicated that more than four out of ten defined benefit plan sponsors are either making or are considering making fundamental changes to their defined benefit plans. About a quarter of those making or considering changes either already have or are inclined to freeze benefits in the plan.

Action on a replacement rate is needed now. Analysts already are steering investors away from companies with a cloudy contribution forecast. Planning for 2004 is already nearly complete. Delay means damage to plans and their participants, damage to companies, and damage to companies' ability to fuel economic recovery.

Why should a composite corporate bond rate be selected as the replacement for 30-year Treasury rates?

The current liability funding rules are designed to shore up funding in a plan that would have a serious shortfall if it were to terminate and need to purchase annuities to provide benefit payments. Thus, as the GAO reported recently, "the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices and not be subject to manipulation." (GAO-03-313)

Insurance companies portfolios mirror investments in long-term corporate debt. Therefore, a composite corporate bond rate will track changes in annuity purchase rates and will mirror the investments used to fund annuities.

ERIC'S composite rate is composed of high-quality, long-term corporate bond indices. High quality bonds (i.e., generally the top two quality levels) provide a conservative level of security for pension plan sponsors to defease their liabilities.

ERIC's composite rate indices also are comprised of bonds with average maturities of 25-30 years (implying durations of 10-12 years), which corresponds to the typical duration of pension plan liabilities.

When the 30-year Treasury bond rate was selected as a compromise for the new pension funding rules established in 1987, Treasury rates were closer to corporate bond rates than they are today. Moreover, mortality assumptions in use at the time were outdated, so having an interest rate that was overly conservative made sense.

The composite corporate bond rate in the ERIC proposal is based on indices that are

- published by major investment houses,
- based on disclosed methodology, and
- publicly available.

The composite rate is

- based on information familiar to plan actuaries;
- simple for plans to implement;
- transparent,
- strongly immune from manipulation, and
- not subject to swings caused by government decisions having nothing to do with pension funding.

What's wrong with selecting another government rate or a yield curve instead of a composite corporate bond rate?

The events of the last five years prove that it is fundamentally flawed to peg pension plan security to any government bond rate. The U.S. government must be free to exercise its legitimate fiscal and monetary policy without wreaking havoc on pension funding.

Any other government rate is going to suffer from the same weaknesses as the 30-year Treasury rate – any relation to annuity funding will be tangential or accidental. Indeed, as the GAO noted (GAO Report –GAO-03-313, p. 5), "Treasury rates' proximity to group annuity purchase rates might be adversely affected if investors' demand for risk-free securities increases, causing Treasury rates to decline relative to other long-term rates."

Government rates reflect the government's fiscal and monetary policy, not the rate of return on an insurance company's portfolio. Thus they are inherently irrelevant as a benchmark for pension funding.

The administration has proposed moving in three years to a corporate bond yield curve – an as yet unconstructed and undefined rate that would be based on projections of future cash flows from the pension plan and that would apply lower rates to more immediate cash flows and higher rates to payouts expected in later years. Corporate bond yield curves bring with them several drawbacks. For example:

- The current liability and its associated funding rules were enacted as two components of a political solution to the problem of habitual under funding of some pension plans. It is inappropriate and unfair to establish a fundamentally new concept for determining the current liability without concurrently addressing the associated funding rules. Indeed changing to a yield curve would require a total re-writing of those rules, which are highly reticulated.

- A yield curve may produce a more "precise" measure of a plan's liabilities, but may well fail to produce a more "accurate" measure. It is, in itself, based on many guestimates, predictions, and assumptions, and, as a spot measure, it ignores the long term nature of pension obligations.

- There has been little public discussion of a yield curve, a complicated proposal. Adequate consideration of a yield curve could not occur under the current time constraints. There are a number of highly technical issues involved in switching to a yield curve that have not been explored or addressed.

- Companies already unsure of their cash flow situation will be thrown into even greater confusion, to the detriment of their ability to participate productively in the economy.

- Since it would make no sense to average a yield curve over four years, an annual rate likely would be used. Unless some other "smoothing" mechanism is devised, this will substantially increase pension funding volatility.

- In addition to decreasing pension funding volatility, the current averaging mechanism gives plan sponsors the ability to estimate funding obligations well in advance of the year for which they are due. Basing contributions on an unknowable "spot rate" decreases the ability of sponsors to plan capital commitments.

- Introducing volatile, unpredictable cash flow requirements is a significant burden on plan sponsors. As a result, maintaining a defined benefit plan will become less and less economically feasible for more companies. It would be impossible to overestimate the negative impact of turning at this point in time to a pension funding system that increased the volatility and unpredictability of required pension contributions.

- A yield curve, combined with the current law deduction limits, could result in less ability for a plan sponsor to fund the plan while participants are younger because it would delay the ability to deduct maximum contributions to periods when the

workforce is more mature and declining, and when the company may face new or different economic pressures. It would, in effect, negate some of the good of the Grassley-Baucus amendment in EGTRRA, which phases out deduction limits that had a similar effect of delaying funding over the past decades.

- If a "precise" interest rate such as a yield curve is mandated, a precise mortality assumption also must be considered. Otherwise, industrial plans whose participants have shorter life spans will be required to excessively fund their pension plan. However, such use of such an assumption is likely to be controversial and will require additional discussion, as it will have different impacts on different plans.

- It is unclear how a yield curve would be applied for purposes of lump sum payments and interest on employee contributions, raising a host of additional issues and possibly resulting in windfalls for some participants and unfair loss of value for others.

- A yield curve is likely to be far less transparent than a composite index; it may be more vulnerable to manipulation; it will be more difficult for the government to police, and it certainly will be more complicated.

A yield curve may impose these drawbacks on the defined benefit system for no real long-term gain over the more simple and transparent approach of a composite corporate bond rate.

WHAT CAN THE SUBCOMMITTEE DO TO HELP?

The Subcommittee has important opportunities to improve the climate for defined benefit plans. It can --

- Convey to the Senate leadership the urgent need to replace the 30-year bond as a benchmark for pension regulation with a composite corporate bond rate.

- Urge or conduct an examination of the long term health of the defined benefit system.

- Ensure that appropriate steps are taken to provide a clearer picture of the long term health of the pension benefit guaranty system.

ERIC appreciates the opportunity to appear before the Subcommittee and will be pleased to respond to questions and engage in further discussions either at or after this hearing.

APPENDIX #1 – PLAIN ENGLISH EXPLANATION OF THE ERISA FUNDING RULES

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, ERISA and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan. These minimum required contributions are calculated using reasonable assumptions and are equal to the normal cost of the plan plus amounts necessary to amortize over specified periods unfunded past service liabilities, experience gains or losses, waived funding deficiencies, changes in actuarial assumptions, and certain other items. Most defined benefit plans are funded under these original ERISA rules, as modified over time.

A plan that is considered either significantly or persistently underfunded will be subject to an additional set of funding rules. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises in the future. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan, accelerating the pace of pension funding. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994, and are the focus of our discussion today.

The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is within a range of rates based upon the four-year weighted average of 30-year Treasury bonds. As amended in 1994, the permissible range is no lower than 90% of the 30-year bond average and no higher than 105% of the 30-year bond average. For 2002 and 2003 only, a plan may use a rate of up to 120% of the 30-year bond average. Congress enacted this short term-higher range last March (P.L. 107-147) in recognition of the fact that, as a result of the rise of budget surpluses followed by the decision of the Treasury to cease issuing 30-year bonds, the 30-year bond rate had dropped to levels that produced highly inaccurate and inflated calculations of pension liability.

The current liability rules come into play if, using these mandated assumptions, a plan is either considered significantly or persistently underfunded -- that is, if plan assets are less than 80% of current liabilities or if plan assets are less than 90% of current liabilities for two of the last three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

Current liability is also calculated to determine whether a plan sponsor will pay a $19 per participant flat rate premium tax to the Pension Benefit Guaranty Corporation, or whether the sponsor must, in addition, pay a variable rate premium tax based on the plan's unfunded vested benefit liability.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.

APPENDIX #2 – INFORMATION ABOUT LUMP SUMS

It is important that the lump sum discount rate reflect the plan's discount rate. Any disconnect between the lump sum rate and the funding rate will cause plan distributions to either exceed or fall short of estimates used in the plan.

Plan sponsors and Congress never intended lump sum payments to unilaterally siphon off a disproportionate share of pension assets. In fact, during the late 1980s and early 1990s, when interest rates were in excess of 7%, the PBGC discussed whether lump sums were inappropriately threatening pension plan security.

Today's low rate also presents participants deciding between a lump sum distribution and an annuity, a choice that is overwhelmingly weighted toward the lump sum. This is in direct contravention of long-established policy that the choice should be economically neutral. As election of lump sums increases, fewer joint and survivor benefits are selected, adversely affecting long-term participant security. In addition, the plan's funding level is adversely impacted, compounding the very problem we are trying to solve. Sponsors cannot eliminate lump sum provisions for already accrued benefits, thus precluding plan sponsor correction of this problem.

- Lump sums paid under a defunct Treasury rate are, in fact, windfall benefits that have damaging side effects for long term retirement policy, for the company sponsoring the plan, and for the PBGC.

- Elderly widows and widowers and others who outlive their assets and have no retirement income stream other than Social Security constitute one of the most vulnerable pockets of poverty today. The current lump sum structure will increase the number of spouses and others left adrift in the future if that lump sum is dissipated.

- Actuarial estimates indicate that a lump sum benefit under the current inappropriate discount rate increases the cost of the benefit to the plan by 17-40%. Many plans cannot absorb these costs and have been freezing or curtailing benefits. Thus, while some current retirees receive a windfall based on an anomaly in the government debt structure, future retirees will receive reduced benefits overall.

- Finally, Internal Revenue Code section 417(e) not only dictates the minimum lump sum rate, but also the rate that regulations encourage companies to use as the interest credit rate in cash balance plans. Thus, maintaining an artificially low lump sum rate for some current retirees means that millions of participants in cash balance plans are losing benefits compared to what they would be earning if the rate were rational.

ERIC proposes that the new interest rate be phased in over a three-year period. The three-year phase-in will align the new and old rates over time while ensuring that the shift

from a defunct 30-year Treasury rate to the composite rate will not have abrupt effects on participants at or very near retirement.

A recent study by the American Academy of Actuaries shows that participants continuing to work will see their lump sum dollar amounts continue to grow during a phase in to a new corporate rate. The effect of the employee's additional accruals and smaller pre-65 benefit reduction outweigh the phase in of the higher rate.

Section 705 of H.R.1776 by Reps. Portman and Cardin provides for a seven-year phase in of the bill's new corporate rate for lump sum calculations. This approach has proved acceptable to both the business community and the AFL-CIO [see May 9, 2003, letter from AFL-CIO to Ways and Means Committee Chairman Bill Thomas].

Historically, the lump sum discount rates have averaged about 7%. The July 2003 mandated rate is 4.93%. Under the ERIC proposal, if current rates remained in effect without change, the lump sum rate would gradually increase to a level of about 5.79% over a three-year period – still short of historical averages. The phase-in is designed to roughly approximate normal fluctuations of interest rates in a given year. Thus, the changes would be within the margins of change that already occur on a year-to-year basis. In addition, in the second and third years, lump sums of many employees would increase from estimates made today because additional years of age and service would be included in the calculation.

APPENDIX #3 – INFORMATION ABOUT MORTALITY ASSUMPTIONS

Under current law, Treasury is required periodically (and at least every five years) to review the mortality table required for current liability funding calculations and to update the table as appropriate to reflect the actual experience of pension plans (including permitting plan-specific adjustment factors such as employment classification, lifetime income, and other relevant demographic factors) and projected trends in such experience. An update in the required table is overdue.

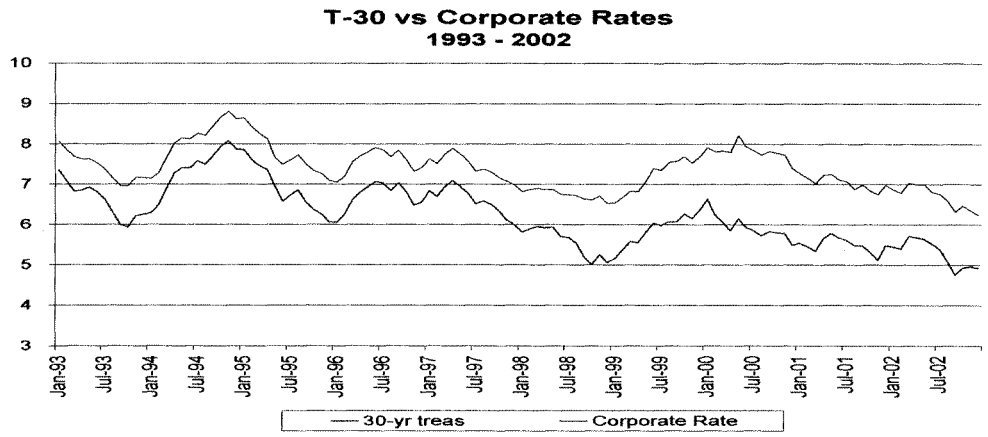
ERIC recommends that the use of the RP 2000 Combined Mortality Table, produced by the Society of Actuaries based on a large study of pension plan experience, be required for funding and variable rate premium purposes at the time the composite rate becomes effective. Use of the new table will have the effect of <u>increasing</u> current liability calculations for most plans, partially offsetting the effects of adopting the composite corporate bond replacement for the 30-year Treasury bond.

ERIC proposes no changes for mortality assumptions for lump-sum distributions, since they already are being updated under a separate provision of law.

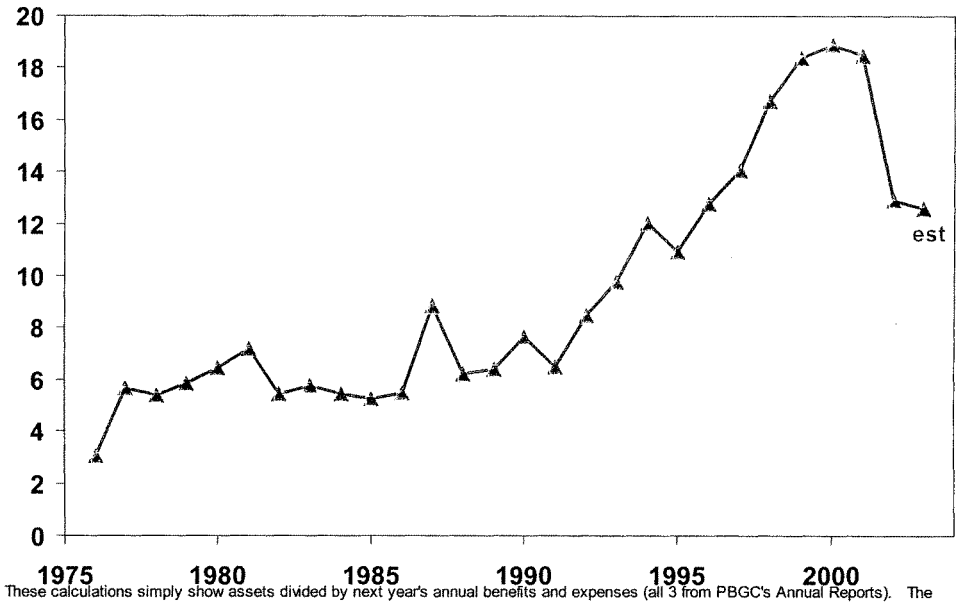
Relationship Between T-30 and Corporate Rates

The spread between Treasury and corporate rates widened in September 1998, and has remained at very high levels thereafter.

	T-30	Corporate Composite Rate	T-30 less Corporate Rate
Current Rates			
12/02 monthly average	4.92	6.23	-1.31
four-year weighted average at 12/02	5.54	7.06	-1.52
Historical Rates			
average of rates for 1998-2002 period	5.63	7.09	-1.46
average of rates for 1993-1997 period	6.83	7.65	-0.82



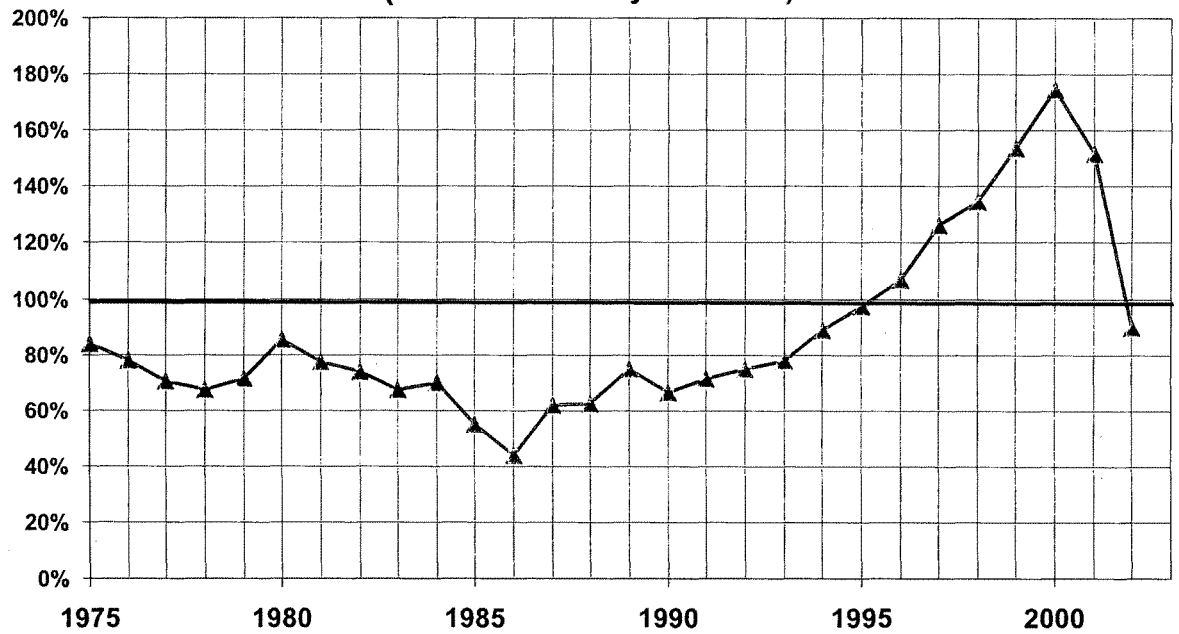
PBGC Assets divided by Annual Benefits + Expenses



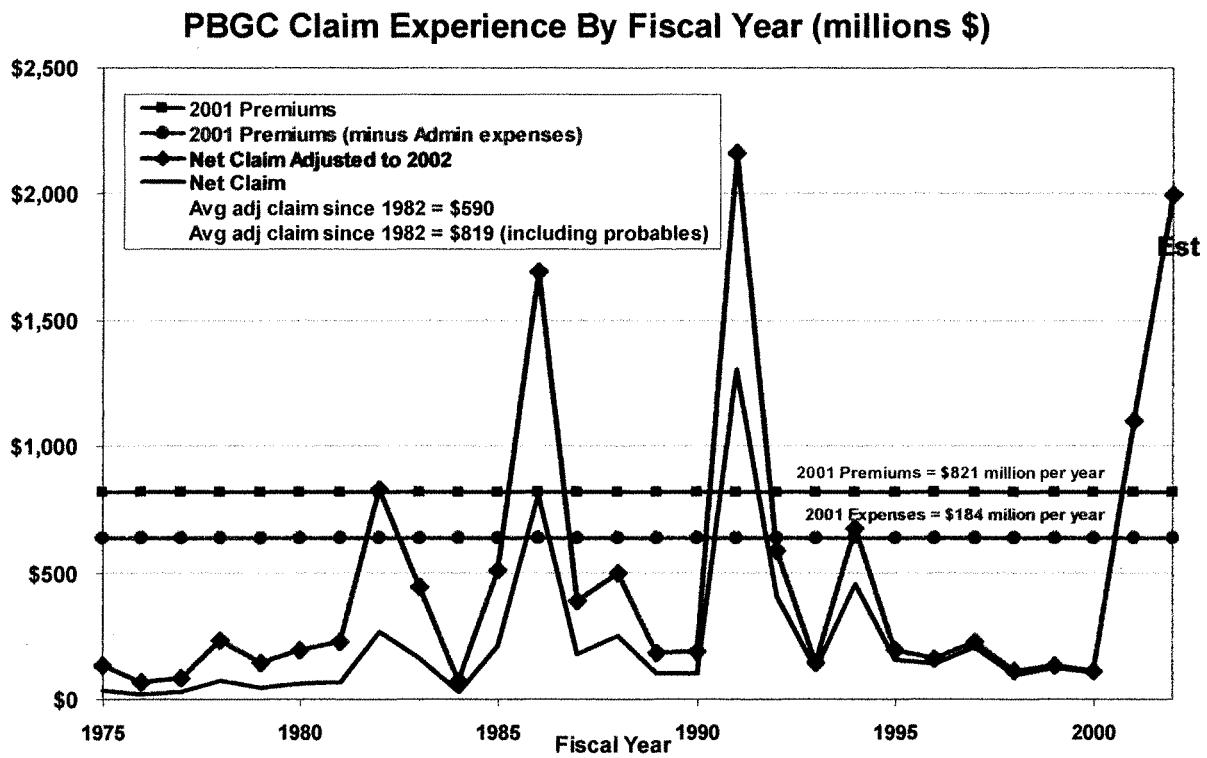
These calculations simply show assets divided by next year's annual benefits and expenses (all 3 from PBGC's Annual Reports). The purpose of this chart is to show that PBGC should have no problem fulfilling its mission of paying pensions, because pension payments are paid out over many years. While the ratio has decreased recently, it is still higher than it was in the 1980's. Since the calculations do not reflect future premiums, future investment income, or future terminations, there should be no inference from this chart as to whether PBGC's future premium income is adequate to cover future claims. (See the later slides for a comparison of claims and premiums.) It should also be noted that future claims bring in additional plan assets. Thus, large claims won't impair PBGC's ability to pay benefits in the near future. Provided at the request of the ERISA Industry Committee by Ron Gebhardtsbauer, American Academy of Actuaries

PBGC's Funding Ratio

(Assets divided by Liabilities)



PBGC assets are 90% of liabilities, which is better than their first 20 years. Percent funded is a better indicator than dollars underfunded. For example, If PBGC is 90% funded, it needs an extra 11% return to get to 100% funded. Note: Since PBGC includes the liabilities of it's probable terminations, we have included their assets also. Provided at the request of the ERISA Industry Committee by Ron Gebhardtsbauer, American Academy of Actuaries



The second adjusted claims amount above includes an estimate of probable claims in the 2002 Annual Report of several billion dollars. How many years should they be averaged over? Is this a once in 20 years event, or once in one hundred years event? Note: Past claims may not be a good predictor of future claims.

AMERICAN BENEFITS COUNCIL

Testimony of

Kathy Cissna

Director of Retirement Plans, R.J. Reynolds

on behalf of the

American Benefits Council

before a hearing of the

U.S. Senate Governmental Affairs Subcommittee on
Financial Management, the Budget,
and International Security

on Pension Funding and Its Impact on the
Pension Benefit Guaranty Corporation (PBGC)

September 15, 2003

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear today on this critically important topic. I am Kathy Cissna, Director of Retirement Plans for R.J. Reynolds. I am appearing on behalf of the American Benefits Council (the Council), where I serve on the board of directors. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

Like you, the American Benefits Council and its member companies are very concerned about the health of the voluntary, employer-sponsored defined benefit pension system. Today, defined benefit pensions face an unprecedented series of threats – many of which, even individually, present a significant danger of undermining our entire pension system. If prompt action is not taken to provide appropriate policy solutions, the erosion in pension coverage that we have witnessed in recent years will accelerate even further, calling into question the continued viability of the defined benefit pension system.

Fortunately, Congress and the Bush Administration can address many of these challenges in a positive manner that will enable employers to continue providing financially sound pension programs to their employees. Let me emphasize that the Council and its members believe that the health of our pension system is vitally important, both to the retirement security of millions of Americans and to the economic security of our nation, and we stand ready to work with you to find solutions to strengthen and preserve defined benefit pension plans. With that, I will attempt to provide some background on the defined benefit system and the current state of pension funding, and then discuss the current threats and opportunities.

Background on Defined Benefit Plans

While the defined benefit system helps millions of Americans achieve retirement income security, it is a system in which fewer and fewer employers participate. The total number of defined benefit plans has decreased from a high of approximately 170,000 in 1985 to about 56,000 in 1998 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today.[1] There has been a corresponding decline in the percentage of American workers with a defined benefit pension as their primary retirement plan from 38% in 1980 to 21% in 1997. Looking at this decline over just the past several years makes this unfortunate downward trend all the more stark. The Pension Benefit Guaranty Corporation (PBGC) reports that it insured 39,882 defined benefit plans in 1999 but only 32,321 plans in 2002. This is a decrease of over seven thousand, five hundred defined benefit plans, or 19 percent, in just three years.

These numbers reflect the unfortunate reality that today's environment is so challenging that more and more employers are concluding that they must terminate their pension programs. Even more disheartening, the statistics quoted above do not even take into account pension plans that have been frozen by employers (rather than terminated), an event that, like termination, results in no additional accruals for existing employees and no pension benefits whatsoever for new hires. If frozen plans were tracked, the tragic decline of our nation's defined benefit pension system would be even more apparent. And unfortunately, there is virtually no precedent for frozen plans "thawing out" such that benefits begin to accrue once again.

These numbers are sobering from a human and policy perspective because defined benefit plans offer a number of features critical for employees' retirement security – benefits are funded by the employer (and do not typically depend upon employees

[1] The decline in sponsorship of defined benefit plans is in stark contrast to the increase in sponsorship of defined contribution plans, such as 401(k)s. According to the same official Department of Labor statistics, the number of defined contribution plans has increased from 462,000 in 1985 to 661,000 in 1997.

making their own contributions to the plan), employers bear the investment risk in ensuring that earned benefits are paid, benefits are guaranteed by the federal government through the PBGC, and benefits are offered in the form of a life annuity assuring that participants and their spouses will not outlive their retirement income. The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances) have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

So, with these advantages for employees, what has led to the decline of the defined benefit system? We see several factors. First, we see a less than friendly statutory and regulatory environment for defined benefit plans and the companies that sponsor them. Throughout the 1980's and early 1990's, frequent changes were made to the statutes and regulations governing defined benefit pensions, sometimes in an effort to eliminate isolated or hypothetical abuses attributable to small employer pension plans. And yet, these rules were applied across the board to employers of every size. The result was that defined benefit pension plans became increasingly expensive and complicated to administer and plan funding and design flexibility was impaired. During this same period, Congress repeatedly reduced the benefits that could be earned and paid from defined benefit plans in order to increase federal tax revenues. Moreover, many companies have found the cost of maintaining a defined benefit plan more difficult in light of intense business competition from domestic and international competitors, many of which do not offer defined benefit plans to their employees and so do not have the corresponding pension expense.

Perspective on Pension Plan Funding

The deterioration in the funding status of many defined benefit plans is attributable in large measure to the current unique combination of historically depressed asset values and historically low interest rates. And indeed, the statistics on plan funding levels can

appear bleak.[2] Yet we must maintain the proper perspective in evaluating the significance of today's numbers. We must recognize that many current measures of funded status use the obsolete 30-year Treasury bond rate to value liabilities. The use of this artificially low and discontinued rate, which I will discuss in more detail below, makes plan liabilities seem larger than they really are and consequently makes a plan's funding level seem more dire than it really is.

Finally, it is important to note that the swing from the abundant pension funding levels of the 1990's to the present state of increasing deficits for many plans is due in significant measure to the counterproductive pension funding rules adopted over the last few decades. Since the first enactment of pension funding rules in the Employee Retirement Income Security Act (ERISA) in 1974, Congress has alternated between strengthening the pension plan system and limiting the revenue loss from tax-deductible pension contributions. Beginning in 1986, Congress limited the ability of companies to contribute to their plans by imposing heavy penalties on withdrawals of surplus assets, lowering the maximum deductible contribution, and imposing a significant excise tax on nondeductible contributions. In 1997 and after, some limited relief was provided, but the overall result is that our laws and regulations strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level.[3] As a result of these statutory changes, by 1995 only 18 percent of plans had a funded ratio of assets over accrued liabilities of 150 percent or more as compared with 45 percent in 1990.[4]

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[2] A January 2003 report from a national consulting firm found that the pension benefit obligation funded ratio – the ratio of market value of assets to pension benefit obligations for a benchmark plan – is near its lowest point in 13 years. *Capital Market Update*, Towers Perrin, January 2003.

[3] The Council strongly supports review and re-evaluation of the basic funding rules that prevent employers from funding their plans generously when economic times are good and then impose draconian funding obligations when economic times are bad.

[4] Table 11.2, *EBRI Databook on Employee Benefits*, 1997, 4th Edition, the Employee Benefit Research Institute, Washington, D.C.

Replacement of the Obsolete 30-Year Treasury Bond Rate

In our view, the need to replace the obsolete 30-year Treasury bond interest rate used for pension calculations is the most pressing issue facing the defined benefit pension system today. Immediate action is required to correct the problem and avoid further erosion in the retirement income security of American families.

Under current law, employers that sponsor defined benefit pension plans are required to use the 30-year Treasury bond rate for a variety of pension calculation purposes, including plan funding requirements, calculation of lump sum distributions, and liability for variable premium payments to the PBGC. The various provisions of federal law requiring use of the 30-year Treasury bond rate for pension calculations were enacted in 1987 and 1994 when there was a robust market in 30-year Treasury bonds and the yields on those bonds were an acceptable proxy for corporate bonds and other long-term debt instruments. While a variety of rates were discussed, it was believed at the time the 30-year Treasury rate was first selected in 1987 that use of the rate would result in companies setting aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

Beginning in 1998, the U.S. Treasury Department began a program of retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year Treasury bonds altogether. With commencement of the buyback program, yields on 30-year Treasury bonds began to drop and to diverge from the rest of the long-term bond market - a divergence that increased precipitously after the October 2001 discontinuation. As a result of the shrinking supply of these bonds (particularly when coupled with continuing demand for the relative safety of U.S. government debt), the secondary market interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other long-term bonds. The Treasury Department itself has concluded,

"[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities."[5]

The result of these low rates is to artificially but substantially inflate pension liabilities and consequently increase required pension contributions and PBGC variable premiums. These inflated pension contributions (which can often be three or four times the normal funding contribution levels) exceed what is necessary to fund promised benefits, contributing perhaps more than any other factor to the spate of plan freezes and terminations in recent years. To illustrate, contributions by Fortune 1000 companies to defined benefit plans averaged $13.7 billion between 1999 and 2001. 2002 contributions by these same companies totaled $43.5 billion, and contributions in 2003 and 2004 are projected to be more than $80 billion per year under the current regime. More than half of these 2003 and 2004 projected contributions are attributable to the inflationary effect of the broken 30-year Treasury bond rate rather than representing cash needed to fund promised benefits.[6]

Today's inflated funding requirements harm the economy since cash unnecessarily poured into pension plans diverts precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers are having to defer steps such as hiring new workers, investing in job training, building new plants, and pursuing new research and development. Yet these are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, and return the country to robust economic growth. Indeed, some employers may be forced to lay off employees in order to accumulate the required cash contributions. Moreover, financial analysts

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[5] Testimony of Peter Fisher, Undersecretary for Domestic Finance, U.S. Department of Treasury, before the House Ways and Means Subcommittee on Select Revenue Measures (April 30, 2003).
[6] These figures and analysis were prepared by Ken Steiner of Watson Wyatt Worldwide, and are contained in his June 26, 2003 testimony on behalf of the Council delivered before the Working Group on Defined Benefit Plan Funding and Discount Rate Issues of the Labor Department's ERISA Advisory Council. *See* http://www.americanbenefitscouncil.org/documents/steinertestimony.pdf

and financial markets have penalized companies with defined benefit pension plans because of the unpredictable future pension liabilities that result from uncertainty as to what will replace the 30-year Treasury bond rate. The resulting pressure on credit ratings and drag on stock prices, which harms not only the company but also its shareholders, is a further impediment to strong economic growth.

Because of these problems and the fact that use of an obsolete interest rate for pension calculations makes no sense from a policy perspective, Congress acted in the March 2002 economic stimulus bill to provide a temporary interest rate adjustment that expires in 2003. Since 2002, the 30-year Treasury bond rate has only become progressively more obsolete, and the associated problems described above have become more grave. In short, the 30-year Treasury bond rate is a broken rate that must be replaced. To continue to base pension calculations on an obsolete interest rate undermines the very foundation of our pension laws and defined benefit plan system, which of course is essential to the financial integrity of the PBGC.

The Council strongly endorses replacing the broken 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. A corporate bond composite rate steers a conservative course that fairly and appropriately measures pension liability. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. Such rates would also provide the kind of predictability that is necessary for company planning of pension costs. Moreover, use of a corporate bond blend would achieve transparency given today's daily publication of corporate bond rates and instant access to market information through electronic means.

Use of such a conservative corporate bond blend would ensure that plans are funded responsibly. Moreover, the strict funding requirements that Congress adopted in 1987 and 1994 would continue to apply. Substitution of a corporate bond blend would

merely mean that companies are not forced to make the extra, artificially inflated contributions required by the obsolete 30-year Treasury rate. This is why stakeholders from across the ideological spectrum – from business to organized labor – agree that the 30-year Treasury rate should be replaced by a conservative, high-quality corporate bond blend.

Senator Judd Gregg, Chairman of the Health, Education, Labor, & Pensions (HELP) Committee, has introduced a bill (S. 1550) that replaces the obsolete 30-year Treasury bond rate with a corporate bond blend for five years. We urge members of this Subcommittee to co-sponsor S. 1550, and we recommend its prompt adoption by the Senate.

The Treasury Department has put forward a proposal to utilize a so-called "yield curve" concept in place of the 30-year Treasury rate, following a transition period during which a corporate bond rate would be used. While a fully developed yield curve proposal has not been issued and the specifics underlying the concept are not yet known, it appears that it would involve a significant change in our pension system to a volatile and complicated regime under which the interest rates used for measuring pension liability would vary with the schedule and duration of payments due to each plan's participants.

Although neither we nor the Congress yet have sufficient detail to fully analyze the Treasury Department's yield curve approach, it raises a large number of policy concerns and unanswered questions that have not been adequately studied or addressed. Based on our current understanding of the concept, we are concerned that the yield curve would:

- ***Exacerbate funding volatility*** by making liabilities dependent not only on fluctuations in interest rates, but also on changes in the shape of the yield curve

(caused when rates on bonds of different durations move independent of one another) and on changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, etc.). The "smoothing" techniques that allow employers to use the average of the relevant interest rate over several years to reduce funding volatility also would not be allowed.

- ***Increase pension plan complexity*** (already a significant impediment to defined benefit plan sponsorship) by moving from a system based on a single interest rate to a much more complex system that relies on a multiplicity of instruments with widely differing durations and rates.[7]
- ***Make it difficult for employers to plan and predict their pension funding obligations*** (another significant impediment to defined benefit plan sponsorship today).
- ***Result in less ability for a plan sponsor to fund pension plans*** while participants are younger because it would delay the ability to deduct contributions to periods when the workforce is more mature. In addition, important flexibility would be lost by removing the corridor surrounding the interest rate (historically 90% to 105% of the averaged rate). The loss of such flexibility would make it harder for employers to fund their plans in times when corporate resources are more plentiful.
- ***Require use of bonds of durations with very thin markets*** (because few such bonds are being issued). As a result, single events (e.g., the bankruptcy of a single company unrelated to the employer sponsoring the pension) could affect the rate of a given bond index dramatically, thereby leading to distortions in pension calculations and even potential manipulation.
- ***Involve a considerable delegation of policy authority*** by Congress to the Executive Branch since the entirety of the construction and application of the yield curve would apparently be left to the regulatory process.

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[7] Although statements have been made that the yield curve adjustment would be simple and easy, the fact that the Treasury Department has failed to provide full details on the proposal, even after months of study, belies the simplicity of the proposal.

- ***Not necessarily result in a more accurate measure of liabilities***, since the theoretically more "precise" plan-by-plan yield curve interest rate would not be accompanied by other similar plan-specific assumptions.

There are many additional unanswered questions created by the Administration's yield curve concept. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest on – and conversion to annuity values – of employee contributions to defined benefit plans, the payment of interest credits under hybrid pension plans, and the calculation of PBGC variable premium obligations.

It is unrealistic to believe that all of these outstanding issues and concerns raised by the yield curve concept could be addressed in the short time in which Congress must act on a replacement for the 30-year Treasury rate. Such an untested change would require a complete reevaluation of our pension funding rules. In addition, it is unclear from the limited information available how the very significant issues of transitioning from a system based on corridors and averaging to a less flexible system would be resolved. At a minimum, to the extent that this type of major overhaul of our pension funding rules is considered, it should be done in the context of a more fundamental review through deliberative Congressional study and the regular legislative process.
This type of more fundamental review would be possible if S. 1550 is enacted since it replaces the 30-year Treasury rate only through 2008. This window of time would allow Congress to decide whether additional changes are warranted.

Administration Proposals Regarding Disclosure and Other Requirements for Certain Plans

The Administration has also come forward with other proposals related to pension funding – namely additional disclosure of pension information and a new idea that would mandate freezes in certain private-sector pension plans – which I also want to

touch on briefly. First, while we certainly support the goal of transparency of pension information, it is important that any required disclosure be responsible and serve a clearly defined need. Disclosure that provides a misleading picture of pension plan finances or that is unnecessary or duplicative of other disclosures could be counter-productive. For example, the Administration's proposal to key disclosure off of a plan's termination liability could provide a misleading depiction of plan finances for ongoing plans that are reasonably well funded because these plans are not in any danger of terminating. This type of misleading disclosure could unnecessarily and falsely alarm plan participants, financial markets, and shareholders. Moreover, termination calculations of the type being proposed are among the most costly and administratively burdensome calculations a plan can be asked to perform. Similarly, the Administration's proposal to allow publication of certain information that today is provided on a strictly confidential basis to the PBGC whenever a plan is underfunded by more than $50 million would provide yet another impediment to companies' willingness to sponsor defined benefit plans, and ignores the size of the plan and its assets and liabilities. For many pension plans with billions of dollars in assets and obligations, such a relatively modest amount of underfunding is often quite normal and appropriate. It should not be cause to trigger publication of information on an ad hoc basis that could again sound unnecessary alarm bells.

We also believe that the Administration's proposal that would freeze private-sector pension plans and remove lump sum rights when a company reaches a certain level of underfunding and receives a junk bond credit rating requires careful review. While we appreciate (and share) the Administration's concerns about PBGC guarantees of benefit promises that are made by financially troubled companies, this proposal raises technical and policy issues that require further examination. For example, there is no definition of "junk bond" status provided, and there is a question of whether it is appropriate to mandate a cutback in participants' benefits based on a third-party's determination of

credit rating. Moreover, it is not clear why employees should lose their rights to certain forms of benefit when their company experiences financial trouble.

Financial Status of the PBGC

Because of concerns about the overall funded status of private-sector pension plans, some have also raised the specter of the PBGC needing to take over more of these plans. This, in turn, has raised some concern regarding the financial condition of the PBGC, and indeed the PBGC has moved from a net surplus to a net deficit in recent years. We believe, however, that the long-term financial position of the PBGC is strong and that while this issue should be addressed, it would be inappropriate to be alarmed and overreact.

At the outset, I want to underscore that the Council has always predominantly represented companies with very well-funded plans. Indeed, the Council has been at the forefront of past Congressional efforts promoting strong funding standards to ensure that the weakest plans would not be able to terminate their plans and impose their liabilities on other PBGC premium payers. Simply stated, the Council has no incentive to trivialize any problems at the PBGC that will come back to haunt us if other companies are not able to keep their promises to retirees.

Nonetheless, while the PBGC's deficit is certainly to be considered very seriously, we do not believe it indicates an urgent threat to the PBGC's viability. Indeed, the PBGC has operated in a deficit position throughout much of its history. Nor does the shift from surplus to deficit over the course of one year suggest the need to change the pension funding or premium rules in order to safeguard the health of the PBGC. Today, the PBGC has total assets in excess of $25 billion, and it earns money from investments on those assets. While liabilities are approximately $29 billion, the annuity pension obligations underlying those liabilities come due over many decades, during which time the PBGC can be expected to experience investment gains to offset any

"paper" deficit that exists today. It is also important to remember that when the PBGC takes over a plan, it assumes all of the plan's assets, but not all of its liabilities. Instead, the PBGC insures a maximum guaranteed normal retirement age benefit for each participant ($43,977 for 2003). While this limits the benefits of some pensioners, it also serves to limit the maximum exposure of the PBGC. The substantial assets that the PBGC holds and the relatively modest size of its deficit when viewed in the context of its capped and long-term liabilities ensures that the PBGC will remain solvent far into the future even under current rules and economic conditions – a point that the PBGC itself has acknowledged repeatedly.

Some have attempted to draw an analogy between the PBGC's financial condition and other financial threats such as the savings and loan (S&L) crisis. We believe that such comments are seriously misplaced. Most important, as just discussed, the PBGC's long-term financial position is strong. Moreover, the PBGC is an entirely different entity than an S&L. S&L depositors had the ability to demand the full amount of their deposits at any time, raising a genuine risk of lack of sufficient funds and creating a fertile ground for financial panic. When assets were insufficient to meet customer demand for deposits, the government was forced to step in and make up the difference. Because pensioners insured by the PBGC have no right to demand their full benefits at a given point in time, rather the benefits are paid out over decades, there is no comparable risk to the government of having to step in to compensate for insufficient funds.

Thus, at this point in time, we do not believe that the PBGC's finances should be cause for alarm. In times of economic hardship, more pension plans (and the companies that sponsor them) confront economic difficulty (including bankruptcy), more pension plans suffer declines in asset values, and more pension liabilities are assumed by the PBGC. At the same time, the PBGC may enjoy sub-par investment gains on its assets while

finding itself responsible for more troubled plans. As the economy improves, this cycle reverses itself, returning the PBGC to robust financial health.

During such periods of hardship, the best protection for the PBGC is to encourage healthy companies to remain in the defined benefit system - not to generate fear with talk of financial crises and potentially detrimental changes to the pension premium and funding rules. The urgently needed policy changes we are advocating today will help achieve this aim and ensure that the PBGC continues to receive a steady stream of premium income from defined benefit plan sponsors.

Simply stated, an important ingredient for a stable PBGC is a healthy and vibrant defined benefit pension system.

Threats Facing Hybrid Pension Plans

Hybrid pension plans (such as cash balance and pension equity) have been a rare source of vitality within our defined benefit system, and have been popular with employers and employees alike. Hybrid plans were developed in part to correct a mismatch between the traditional pension design and the needs of today's mobile workers. The traditional pension design disproportionately awards benefits to employees with very long service relative to employees with less than career-long employment at their firm. Yet we know that today most employees change jobs frequently. Indeed, in today's mobile workforce, numerous studies show that the more even benefit accrual formula of hybrid pension plans delivers higher benefit levels to the vast majority of workers. At the same time, hybrid plans include the features that make traditional defined benefit pension plans popular with employees - namely, an insured, employer-funded benefit for which the employer bears the investment risk. Today, according to the PBGC, there are more than 1,200 hybrid pension plans in the U.S., covering more than 7 million employees.

Nonetheless, these plans also face serious threats that endanger their continued existence. Unfortunately, the rules applicable to defined benefit plans have not been updated to reflect the development and adoption of hybrid pension plans, leaving unresolved a number of pressing compliance issues regarding hybrid plans. Pending at the regulatory agencies are several projects to provide needed guidance to address these unresolved issues. These pending regulatory projects need to be completed, but there have been efforts to use the current appropriations process to deny funding for such projects by some who believe that traditional defined benefit plans are the only type of pension design that should be allowed for certain employees. In the House, some of these opponents have used the Transportation-Treasury appropriations bill (H.R. 2989) as a vehicle to express both their support for a recent federal district court decision addressing pension age discrimination that is out of step with other legal authority, and their opposition to completion of the pending regulatory projects on hybrid plans. These types of efforts to affect complex pension policy through the appropriations process should be rejected, and are strongly opposed by the Council. If the Treasury Department and IRS are prevented from resolving the outstanding legal issues involving hybrid pension plans, the resulting uncertainty will lead many employers to abandon these plans, further eroding Americans' retirement income security.

We are also concerned about legislative proposals (S. 825 in the Senate and H.R. 1677 in the House) that would mandate that employers converting a traditional defined benefit plan to a hybrid pension plan allow employees to elect at retirement whether they wish to receive their hybrid pension plan benefit or a benefit equal to what they would have received if their traditional defined benefit plan had remained in existence. Our voluntary pension system is premised on the idea embodied in current law that benefits already earned are absolutely protected (the "anti-cutback" rule) but that employers have flexibility to adjust to changing circumstances by increasing or decreasing benefits that will be earned in the future. Under the mandated choice legislation however,

businesses would be unable to alter future benefit levels in conjunction with a conversion as employees could simply choose to receive benefits under the prior formula. Yet business circumstances – such as increased international competition, the presence of competitor firms with lower or no pension expense, possible company bankruptcy, the need to attract new workers, or employee preference for a reallocation of benefit dollars – sometimes necessitate adjustments to pension plans.

In no other area do we prevent employers from altering employment conditions in such a manner. Employers may cease employing individuals, change pay levels, alter working conditions, revise health coverage, even drop or freeze a pension program. Yet under the mandated choice proposals, employers that adopt a hybrid pension must keep the prior traditional pension forever for current employees. This would radically depart not only from the norms of our voluntary pension system but indeed from basic American workplace principles, forcing prudent businesspeople – who will be unable to make these unalterable benefit commitments – to depart the defined benefit system as quickly as possible.

Additional Defined Benefit Issues of Importance

I also want to mention briefly two other policy issues of importance to the defined benefit system.

- *Making the 2001 Pension Reforms Permanent.* The 2001 tax act contained a number of very positive changes to the rules governing defined benefit plans. These included repeal of artificial funding caps, increases in the benefits that can be paid and earned from defined benefit plans, and simplifications to a number of defined benefit plan regulations. We support making the 2001 retirement savings reforms, which are scheduled to sunset at the end of 2010, permanent so that employees and employers can have the long-term certainty so necessary for pension planning purposes.

- *Pension Accounting.* The Council is very concerned about some ominous developments concerning the accounting standards for pension plans. Accounting standard-setters, led by those in the United Kingdom, are pushing to require companies to reflect the full fluctuation in pension asset gains and losses on the firm's financial statements *each year,* thereby prohibiting companies from amortizing such results over a period of years as they do under today's accounting standards. This new "mark-to-market" approach is inconsistent with the long-term nature of pension obligations, produces extreme volatility in annual corporate income, and has prompted 75 percent of British pension sponsors to consider terminating their plans. Given the many other challenges faced by sponsors of defined benefit plans, abandonment of current U.S. accounting standards for this "mark-to-market" approach would be devastating.

Conclusion

We thank you for the opportunity to present our views on what the Council believes are some of the most important retirement policy questions facing our nation. Defined benefit plans offer many unique advantages for employees, and the employers such as R.J. Reynolds that sponsor these pension plans sincerely believe in their value. Without prompt action by Congress and the Administration however, we fear these plans will increasingly disappear from the American pension landscape.

I would be pleased to answer whatever questions you may have. Thank you.

STATEMENT OF NORMAN P. STEIN
ON BEHALF OF THE
PENSION RIGHTS CENTER
ON
"SAFEGUARDING AMERICA'S RETIREMENT SECURITY:
AN EXAMINATION OF DEFINED BENEFIT PENSION PLANS AND THE
PENSION BENEFIT GUARANTY CORPORATION"
BEFORE THE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND
INTERNATIONAL SECURITY
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
SEPTEMBER 15, 2003

Mr. Chairman, Members of the Subcommittee, I am Norman Stein, a professor at the University of Alabama School of Law, where I am privileged to hold the Douglas Arant Professorship. I also direct the law school's pension counseling clinic, which, with funding from the United States Administration on Aging, has been able to help hundreds of individuals with their pension problems.

It is also my privilege to appear here today on behalf of the Pension Rights Center, the nation's only consumer organization dedicated solely to protecting and promoting the pension rights of workers, retirees, and their families.

The issues you are looking at today, the "crisis" in pension funding and the challenges facing the Pension Benefit Guaranty Corporation, are difficult, and fuse together broad issues of economic and social policy with arcane concepts of actuarial science. But these issues are critical not only to the participants in defined benefit plans and to their families, but also to the economic and moral health of our nation. The decisions that we, as a society, make in the near future about the defined benefit system will have profound implications for the future retirement income security of the millions of employees and retirees now participating in that system, the economic viability of the firms that sponsor them, and the long-term sustainability of the traditional defined benefit plan, which is the crown jewel of our private sector retirement system.

I will divide my testimony into three sections. The first will offer some preliminary observations about the Pension Benefit Guaranty Corporation. The second will discuss possible changes to the funding rules for defined benefit plans. The third section will address suggested other modifications to the defined benefit regulatory regime, particularly Title IV of ERISA, which establishes the PBGC and regulate most terminations of defined benefit plans.

Preliminary Observations

1. Is the PBGC really in crisis?

First, it is important to note that the PBGC's deficit status is not a new phenomenon. As the GAO has reported, "Over the last decade the program swung from a $3.6 billion accumulated deficit (liabilities exceeded assets), to a $10.1 billion accumulated surplus, and back to a $3.6 billion accumulated deficit, in 2002 dollars." However, the fact remains that the PBGC has in a short period of time gone from a healthy surplus to a troubling deficit. How has this happened? Conventional wisdom has it that there are three reasons, or at least three significant reasons, for the PBGC's current large deficit.

The first reason is that economic factors—including low interest rates, poor performance in the equity markets, the recession, and structural problems in certain sectors of the economy—have resulted in the termination of several defined benefit plans with large unfunded guaranteed liabilities. The second reason is that low interest rates have increased the present value of the PBGC's future obligations to pay guaranteed benefits in plans it has taken over. The third is that the PBGC's investment portfolio has declined in value. Some have called the combination of these three factors a perfect storm.

But how long will this perfect storm last? The first reason for the PBGC's problems—the termination of large plans with unfunded liabilities—is largely permanent: the plans that the PBGC has taken over are ordinarily with the PBGC until the death of the last beneficiary of the last participant in the plan. But the other two reasons—storm fronts in the perfect storm—may be transitory and move on. (Indeed, let us hope they are transitory.) Interest rates may not stay at their current low levels and the equity markets may rebound. If this happens (and it may already have started to happen), the PBGC's financial situation might improve dramatically and this perfect storm may turn out to have been the perfect tempest in a teapot.

Moreover, the orthodox explanation for the PBGC's situation is incomplete. Some of the problems with plan underfunding are attributable not simply to external economic factors but in some cases to actions of the firms that sponsor such plans. In a July 10, 2003 *Wall Street Journal* article, "Firms Had a Hand In Pension Plight They Now Bemoan," journalist Ellen Schultz described some of these actions. In the article, Schultz writes that, "Over the past decade, U.S. companies have siphoned off billions of dollars in assets from their pension plans. They've used the cash to pay for retirees' health coverage, the costs of laying off workers and even fees to benefit consultants." The article goes on to say that, "many employers have been putting less money into pension plans in the first place, because they adopted structural changes that made the plans appear better-funded on paper."

Other commentators have suggested that the two-decade-long shift to 401(k) plans has played a significant role in the shrinking of the PBGC's premium base. Firms are increasingly terminating their defined benefit plans in favor of defined contribution plans that do not pay premiums to the PBGC. Thus, economic conditions are not the only cause of plan underfunding.

But to return to the initial question, is the PBGC in crisis? If the question is whether the PBGC is in danger of defaulting on its benefit obligations during the next couple of decades, the answer is no. If the question is whether the PBGC faces challenges in the years to come, the answer is: of course. But we cannot predict with certainty how deep and enduring the PBGC's current financial problems will prove. Indeed, today's so-called perfect storm would resemble a balmy fall day in Maine for the PBGC if the PBGC valued its liabilities using the corporate bond rate that some in Congress and the private sector are advocating for use by private plans to value the very liabilities that the PBGC insures. I have spoken with several actuaries who estimate that such an alchemic change would magically reduce PBGC's aggregate liabilities by between 5% and 15%, substantially reducing or almost eliminating its deficit. One should also note that while the PBGC includes the cost of some anticipated plan terminations in its liabilities, it includes no part of future premium income in its assets.

But it is also clear that we should not wait out this "perfect storm," even though it may, as we suggest turn out to be an aberrational blip in our nation's economic climate. The current situation affords us a unique opportunity to begin the hard political process of shoring up the funding rules for defined benefit plans and addressing structural problems affecting the PBGC, as well as ending inequities affecting workers that have come to light in recent months. But this is certainly not the time for the radical measures that some—including this Administration—have proposed to reduce PBGC benefit guarantees. Such measures would be unfair, unneeded, and unwise.

2. The PBGC's Split Mission and Premium Structure

The PBGC is sometimes criticized as if it were simply a commercial insurer with a bad business model: its premium structure is not adequately risk-based and its benefit guarantee program creates moral hazard. But Congress never intended the PBGC to be, or act like, a pure insurance company. The creation of the PBGC in 1974 also reflected a social insurance goal: that participants should not lose all benefits when an inadequately funded defined benefit plan terminates.

While it is true that this social insurance goal could, in theory, have been accommodated in a true insurance model, such a model would have saddled some underfunded plans with staggering liabilities. This was apparently unacceptable to Congress in 1974, when ERISA was enacted. Thus, Congress instead fashioned a premium structure that ignored risk in favor of imposing a flat per-participant premium on all plans. This meant that firms sponsoring adequately funded defined benefit plans were required to subsidize underfunded plans.

Congress has since 1974 revised the PBGC's premium structure to take risk into account, but plans that do not pose significant risk to the PBGC continue to subsidize plans that do pose such risk. In effect, the premium for a low-risk plan has two components: an insurance premium for insurance of the plan's benefits; and a separate charge that enables the PBGC to fulfill its social insurance function of ensuring benefits in plans that do not pay a fully risk-adjusted premium. In effect, the PBGC's current

premium structure assesses a tax against firms who sponsor low-risk defined benefit plans.

3. Disclosure and Transparency

The GAO has suggested that there should be greater transparency—to participants, investors, and government regulatory bodies—of the funding status of defined benefit plans. We agree with the GAO that more complete and current information on a plan's funding status is critical to the health of our private retirement system. The need for such information has been dramatically highlighted by the recent tragic and apparently unnecessary loss of expected pension benefits by USAirways pilots who were not given accurate information about the their plan's financial status in time to effectively protest its termination by a bankruptcy court.

Funding of Defined Benefit Plans

The current funding rules for defined benefit plans have not proven adequate to ensure that all, or even most, defined benefit plans will always be sufficiently well funded to satisfy their benefit commitments. In the long run, the funding rules must be redesigned to better reflect a plan's actuarial realities. On the other hand, the funding rules should, to the extent possible, facilitate predictable and relatively smooth annual funding obligations. And if the funding rules are to be strengthened, Congress should provide an adequate transition period to allow firms to adjust to the new rules and the higher contribution levels to which some plans would be subject.

Although we do make some specific suggestions to the funding rules, we caution that the entire funding regime for defined benefit plans should be examined. A firm's funding obligations to a plan are ultimately determined by the interaction of all of the funding rules; it is unlikely that changes to a few isolated rules will result in meaningful improvement of the defined-benefit plan funding scheme.

We also note that there is tension between concerns that the defined-benefit funding rules do not adequately ensure plan solvency and concerns that volatility in contribution demands under funding rules impede corporate planning and performance. It may be that the two concerns can only be adequately resolved through changes in the construction of a plan's investment portfolio, but that is an issue that requires a candid, and exhaustive, debate among actuaries and investment professionals. Policymakers should have their ears attuned to this debate.

Our specific comments and recommendations follow:

1. The Department of Treasury has suggested that the interest rate for discounting plan liabilities be increased from the 30-year treasury rate to long-term corporate bond rates. The result of such a change in many cases would be a reduction of a firm's plan contributions and exacerbation of plan underfunding. In addition, the corporate bond

rate lacks adequate conceptual justification: such rates are higher than the discount rate that would be used by an insurance company in valuing a plan's liabilities and the corporate bond market is thin, particularly with respect to bonds with long durations. Moreover, corporate bond rates are subject to risk, although Title IV purports to make payment of benefits riskless to participants up to PBGC guarantee levels. The appropriate discount rate should therefore be pegged to riskless, or nearly riskless, instruments, such as government-issued bonds.

To the extent that the proposed change in interest rate is designed to ease temporarily the funding volatility to which some firms recently have been subject, we would prefer the use of mechanisms that are specifically designed to provide temporary shelter from increased contribution obligations. For example, Congress might temporarily reduce the funding ratio that triggers the deficit reduction contribution or permit firms to apply for a funding waiver of the DRC or permit firms to securitize a portion of their liabilities in exchange for partial waiver of the DRC. Another approach might be to permit "experience losses" resulting from the bear market of the past few years to be amortized over a longer period of time. But we do not think that the short-term cash-flow issues facing some firms are best solved by adopting an unwarrantedly high interest assumption that would likely become a permanent fixture in the law and thereby imperil the future solvency both of plans and the PBGC.

2. The Administration has proposed that plan liabilities be discounted to present value (for certain minimum funding purposes) using a yield curve derived from interest rates on high-quality corporate obligations. For some plans, such a yield curve may actually reduce funding obligations, which we think is counter-productive to the Administration's purported goal of improving plan funding; for other plans—those with a mature workforce and many retirees, a yield curve would substantially increase funding and perhaps force bankruptcies and create job loss in important sectors of our economy.

These economic consequences to firms and their employees should not be ignored in the funding debate. And we also believe that changes that will add funding stress to challenged sectors of the economy must not be made in a funding vacuum: some changes—for example, mortality tables tailored to reflect the shorter life expectancies of employees in some industries and in some mature plans—should be considered as part of the same debate over funding of which the proper discount rate is but one part. We do not endorse the idea that the optimal solution to plan underfunding is to mortally wound the plan's sponsor.

3. Some groups have suggested that the full funding limitation should be increased so that employers can make large contributions in profitable years, which would then reduce contribution obligations in less profitable or loss years. We are skeptical that this would do much to improve the funding of at-risk plans, since we suspect that increased contributions would primarily be made by the strongest firms, which would have an interest in using the plan's tax-exempt status to favorably fund future payroll costs. Nevertheless, the only harm to increasing maximum contribution obligations is loss of potential tax revenue. One means of permitting increased funding, while controlling the

resulting revenue loss, would be to retain the limits on immediate deductibility of contributions in excess of the full funding limit, but to remove the excise tax on such contributions. In any event, the full funding limit should be based on ongoing liabilities, including the effect of anticipated future inflation on such liabilities, as discussed in 4. below, liabilities should reflect the effects of anticipated inflation.

4. The funding rules should require (or at the very least permit) funding of benefit improvements that are due to anticipated inflation. This would require changes in IRC 412 to permit funding of benefits in excess of nominal section 415 limits. This rule should also apply to predicted benefit increases in plans where benefits are stated in dollar amounts rather than percentage of pay. Such plans are common among blue-collar workers.

5. We agree with the General Accounting Office that loopholes that permit plans to avoid paying the DRC should be closed.

The PBGC Insurance Program

The surest way of improving the PBGC's long-term fiscal health is to increase the potency of the funding rules and the health of the economy. We have already suggested some approaches to the former and have not been asked to express our views on the latter. But this leaves the issue of whether Title IV itself needs major structural change. At the beginning of our testimony, we suggested that the PBGC is not currently in crisis and that it is neither necessary nor wise to consider legislation that would reduce employee security in their benefits and thereby reduce public confidence in defined benefit plans. Neither do we think steep premium increases are called for: we think such increases could have the perverse effect of causing healthy firms to abandon defined benefit plans to avoid the premiums. Moreover, in general, resources are best utilized when they are contributed to underfunded plans rather than the PBGC; no dollar paid to the PBGC directly improves a plan's funded status.

Our specific ideas about Title IV are summarized below:

1. We just noted that in general we would prefer sponsors of stressed plans bear increased contribution obligations to their plans rather than increased premium payments to the PBGC. This approach would make it less likely that a plan will terminate with insufficient assets and more likely that plans that do terminate will be closer to solvency. Indeed, we might require that some portion of today's variable premiums be redirected to the plan, perhaps in a segregated fund that would not be subject to the normal Title IV asset allocation rules.

It is true that a variable premium has some positive incentive effects: for example, it can discourage a firm from amending an underfunded plan to create new unfunded liabilities and encourage financially healthy firms to improve their plan's funding. (Ultimately, though, the plans of healthy firms pose less risk to the PBGC than the plans

of financially stressed firms). But there are other mechanisms that might be adopted to protect the PBGC from poor firm behavior.

2. There might be periodic or episodic appropriations to the PBGC from general revenues (which might be paid for by a partial rollback of the recent increases in IRC Section 415 and elective contribution limits, which have reduced taxes for the wealthiest individuals while doing little to improve retirement security for average American workers). Such appropriations are, we believe, justifiable, since much of the funding issues that defined benefit plans are today experiencing have resulted from federal fiscal policy (and the ill-advised decision to stop issuing 30-year debt instruments), which have driven down interest rates: the government bears heavy responsibility for today's so-called funding crisis.

Moreover, as we earlier observed, the PBGC serves not only an insurance function, but also a social insurance function. Currently, firms with low-risk defined benefit plans fund the social-insurance mission of the PBGC by paying premiums that are larger than needed to cover the risk of their plans terminating with insufficient assets. In effect, this is a tax on such firms. It might be fairer to shift part of this burden to a wider universe of taxpayers.

3. To prevent flight of healthy firms from the defined benefit system, an exit charge (or withdrawal liability) might be imposed on employers who voluntarily terminate their defined benefit plans. When they leave the system, they saddle a larger portion of the PBGC's unfunded liabilities on the employers who remain behind; in effect, the system currently rewards those who desert the system by relieving them of future premium responsibility.

4. Rules should be adopted to deter the practices documented by the *Wall Street Journal* where firms siphoned off plan assets for non-pension purposes in years when economic conditions were more favorable, thus diminishing the plans' assets. When a plan appears overfunded, the assets in excess of the present value of plan liabilities should be regarded as a rainy-day fund for harder economic times, which the business cycles of a market-driven economy ensure will recur.

5. The PBGC has suggested that the law be amended to reduce PBGC benefit guarantees for plant shutdown benefits. This would be ill-advised. Plant shutdown benefits are critical benefits for employees at a time when they are subject to particularly harsh economic dislocations. Those benefits are currently insured and to suddenly cancel them would be to break faith with some of the nation's most vulnerable workers.

In any event, discussion of benefit cutbacks would only be appropriate if the PBGC were in true crisis, which it is not, and if every other approach short of reducing benefit guarantees has been tried, which they have not. Moreover, if reductions to PBGC guarantees are *ever* to be made, they should apply only to benefits created in the future; benefits already in existence should never be on the butcher block.

6. Under current law, guarantees for benefit increases are phased in over five years. An oddity in the law, however, treats inflationary benefit increases to be immediately guaranteed in some plans (those that are based on a final pay formula), but not for other plans (for example, plans that use flat dollar or career average benefit formulas). The former plans generally cover white-collar employees, the latter blue-collar workers. The rationale for the disparate treatment is that the benefit increases that result automatically from a final pay plan are permitted to be advance-funded while the benefit increases under other formulas are not permitted to be advance-funded. We have already suggested that the funding rules be revised to correct this disparity on the funding side; the disparity should also be corrected on the guarantee side. The benefit phase-in should apply only to real-dollar benefit increases, not (advance-funded) increases that simply permit benefits to keep up with inflation.

7. Many pension plans provide participants with the opportunity to elect to receive their benefits as single sum amounts, and most pension plans actually force participants to take lump sums if the value of their benefit is less than $5,000. In determining the value of the benefit, and hence single-sum amount the participant will receive, the Internal Revenue Code requires that the plan use an interest factor equal to interest on a 30-year treasury bond. Some trade groups and employers, and the Administration, argue that plan solvency would be helped if the discount rate were changed to corporate bond rates, which would have the effect of substantially reducing the value of such single-sum payments.

While the Pension Rights Center has never been an advocate of lump sum distribution options, it has always taken the position that once a firm promises an employee a benefit, it should not be able to break that promise. Employees view pension plans as contracts and the interest rate used for valuing lump sums is a part of those contracts. Those who would change the interest rates are, in effect, asking Congress to relieve them of a bargain they made with their workers.

Some who advocate reducing the value of lump sum benefits argue that it is unfair that employees are electing to take their benefit in lump sum form because lump sum benefits are economically more valuable than annuity benefits. But since when in our economic system is it wrong for people to choose the most advantageous contractual option available to them? Moreover, when an employee elects a lump sum benefit, the employee loses the insurance protection provided by the PBGC, which itself has economic value. And we doubt that most working people will be able to realize a rate of return equal to the interest rate on corporate bonds, at least without exposing themselves to substantial market risk. Finally, in some cases, employees choose lump sums not as a wealth maximizing strategy, but simply because they do not trust their former employer with their money. Indeed, in many cases where a plan offers a subsidized early retirement benefit, the lump sum—even with its value being determined with a discount rate equal to the interest rate on a 30-year treasury obligation—can exclude the subsidy and thus be worth substantially less than the annuity benefit. Yet many workers nevertheless select the less valuable lump sum.

Whatever the merit of the argument for allowing employers to break their contractual obligations to people who have a choice of whether to take a lump sum or annuity benefit—and we think the argument has very little merit—there can be no reasonable argument that we should reduce lump sums for workers when their employers "force" them to take lump sums. Such workers, because of the small amounts they receive (less than $5,000), will have limited investment opportunities and will not be able to achieve a rate of return equal to the corporate bond rate. In addition, empirical research shows that the larger the lump sum, the more likely it is that an employee will save some of it for retirement by rolling it over into an IRA. Reducing the amount of the lump sum for these employees will thus contribute to asset leakage from the retirement system. Finally, increasing the interest rate will increase the number of employees who will be forced to take a lump sum, for a larger number of annuity benefits would have a present value of less than $5,000.

We are, however, troubled by one aspect of lump sum distributions highlighted in a recent *New York Times* article ("A Lump-Sum Threat to Pension Funds" by Mary Williams Walsh, August 14, 2003) pointing out that some employees with benefits that exceed PBGC maximums pull their uninsured benefits out of financially distressed plans as lump sums. If the plan terminates, they will have already received a lump sum that reflected, in part, a non-guaranteed benefit. The idea of limiting lump sums from distressed plans (perhaps those subject to the DRC or the variable rate premium) to the guaranteed benefit and paying the difference in annuity form is in our view worth exploring.

8. Finally, we agree with the General Accounting Office that certain loopholes that permit plans to escape paying the variable rate premium should be re-examined.

I would be happy to answer any questions you may have.

AMERICAN ACADEMY *of* ACTUARIES

U. S. Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget, and International Security

Hearing:

Safeguarding America's Retirement Security: An Examination of Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation

Testimony Presented by:

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American Academy of Actuaries

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The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

Introduction

Chairman Fitzgerald, Ranking Member Akaka, and distinguished committee members, thank you for inviting me to testify on the "Defined Benefit Plan Funding Crisis." My name is John Parks, and I am the Vice President for Pensions and Chairperson of the Pension Practice Council of the American Academy of Actuaries. My testimony today is a reflection of input from numerous members of the Academy's pension committees and other actuaries.

The Academy's Pension Practice Council and its committees are made up of senior actuaries who work for large and small consulting firms, insurance companies, unions and corporations and provide professional advice representing all types of retirement programs from our nation's largest plans to single entrepreneur arrangements, from not-for-profit organizations to corporations and multiemployer funds. Our council members are committed to providing objective information and analysis to ensure the viability of our national voluntary retirement system and to support the position that defined benefit (DB) retirement programs provide a vital form of retirement security for the American people.

Background and Challenge

The challenge of retirement economics is not faced by our nation alone but in many aspects is shared globally. The combined impact of increased life expectancy and reduced fertility rates has commanded that all nations look for solutions that are reasonable and can be relied upon by current and future retirees. Declines in the equity market and reduced interest rates are currently creating an even greater challenge to cohesive and effective retirement systems. While many of the issues are global in nature, this testimony will deal with the specifics as they relate to our nation.

In addition to the recent (and hopefully temporary) funding crisis we must also remember that for at least 10 years, perhaps 20, there has been a steady shift away from guaranteed retirement income and toward self-annuitization. The danger in this transfer of financial risk to individuals is largely unseen because the people affected have mostly not yet retired. We must deal, therefore, not only with current (and perhaps temporary) financial conditions but also with the long-range challenges facing DB plans in general.

"Pensions 101" taught us many years ago that an excellent voluntary employer supported retirement program (supplementing an effective Social Security system) is the combination of defined benefit and defined contribution (DC) plans. The defined benefit plan provides a base monthly retirement income guaranteed for life and the defined contribution plan – typically a 401(k) - allows both the employer and the plan participant to supplement that income. The defined contribution plan could and has under the right market conditions allowed for significant wealth generation. The foundation, however, remains the defined benefit pension plan. It is a critical part of this retirement economics challenge to see that defined benefit plans are supported and plan sponsors are provided with the incentive to maintain and cultivate these programs. Some special advantages of DB plans include:

- For employees, DB plans provide a secure, stable income for life. Employees won't have to worry about risks, such as a bear market when they want to retire or after they retire, or outliving their money. DB plans are an effective device for spreading mortality risk for the retirees and can only be achieved through such a plan of formal annuitization.

- For employers, DB plans can provide contribution flexibility and are better at keeping a stable workforce. They are also usually professionally managed and, therefore, achieve similar or higher returns with less risk than a typical employee-directed account (per Table E24 of the 1998 DOL Form 5500 abstract).

- For the nation, DB plans help reduce our dependence on social programs, such as Medicare, Medicaid, and Supplemental Security Income (SSI) and they reduce poverty among the elderly more effectively than defined contribution plans.[1]

In 1975, just after the Employee Retirement Income Security Act (ERISA) was signed into law, 40 percent of the labor force participated in a DB plan, and 16 percent participated in a DC plan (see chart, *Participation Rates in Pension Plans*, at end of testimony). Today, however, the reverse is true: only 21 percent participate in a DB plan, while 46 percent participate in a DC plan.[2]

The challenge is finding an effective balance between the universal goal of providing secure retirement income and the often-conflicting needs of protecting the participant, finding reasonable funding and accounting solutions for the sponsoring employer and managing the risk to the Pension Benefit Guaranty Corporation (PBGC). These written comments will explore the following related and important issues for this hearing.

- Funding (the systematic accumulation of funds to meet current and future obligations to plan participants)
  - Simplification of the rules
  - Maximum tax-deductible contributions
  - Addressing withdrawals

- Solvency (the ability of a plan to meet its obligation to participants in the event of a catastrophic corporate event such as corporate reorganization or bankruptcy)
  - PBGC concerns
  - Fixing the discount rate

- Accounting (the appropriate representation of the net obligation, particularly for public companies, to allow for the accurate assessment of the organization's ability to meet this obligation along with its other business financial needs)

The frameworks for two of these three factors, solvency and funding, are defined by federal laws and regulations, while the accounting framework is defined for the most part by the Financial Accounting Standards Board (FASB). Each factor needs to be addressed, considering the applications for the primary audience, but we must also consider the ramifications for plan sponsors and participants if we want to develop effective retirement policy for the country.

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[1] Additional advantages can be found at http://www.actuary.org/pdf/pension/testimony_20june02.pdf

[2] The 2000 Form 5500 data are not available yet, because pension plans file about nine months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

Funding – Simplifying the Rules

Years of almost annual amendments to ERISA have continually increased the administrative burden on those who try to maintain defined benefit programs, putting many employers at a disadvantage. Those companies who sponsor DB plans are now questioning the future of their programs under the current financial strains of the economy; mandated, overly rigid and short range funding requirements; accounting difficulties; arcane pension laws and regulations; and the uncertainty they face with this type of plan.

There are many different aspects of today's economic environment that threaten the voluntary DB system. The decline in equity markets and interest rates has (at least temporarily) simultaneously caused the assets supporting pension funds to decline and the funds' liabilities to increase. These two forces have dramatically shifted the funded status of most, if not all, DB plans. Funding requirements have not only increased to compensate for lower investment returns over the past three years, but the simultaneous decline in 30-year Treasury rates has triggered additional funding under the deficit reduction contribution (DRC) requirement of Internal Revenue Code (IRC) Section 412(l).

The stakeholders for funding are the taxpayers, participants, and plan sponsors. Funding and tax deductible contributions translate to federal revenue cost and are also a reflection of deferred compensation for employees.

Simplification is necessary to reduce the regulatory cost of DB plans, level the playing field for defined benefit plans and defined contribution programs, and provide a viable system with stable rules to attract new plan adoption – all of which are needed to meet the financial security of retiring Americans. For example, there are 11 different amortization periods/rules (including the separate rules for multiemployer plans) for paying off liabilities in the funding rules in IRC Section 412(b) [Funding Standard Account] and two more in Section 412(l) [Additional Funding Requirements]. The accounting standards only have three rules (working lifetime, retiree lifetime, and period benefits for frequent amendments). In addition, the IRC rules create disconnects between the payment of benefits and the funding of benefits. They allow employers to improve retiree benefits (which are payable over 10 to 20 years) and pay for the improvement over 30 years, which can hurt a pension plan's funding levels. On the other hand, underfunded plans must pay off their deficit in three to seven years under IRC Section 412(l), so the amount of required contributions can be very volatile when plans are forced to go from 30-year funding rules to 7-year funding rules. In fact, the volatility is even more dramatic for plans that were prohibited from making deductible contributions in the late 1990s, and now must fund their deficits over seven years (see the attached chart labeled *Current Contribution Rules*).

This problem did not happen when the rules were implemented. In the 1980s, current interest rates were significantly higher, so the current liability (CL) was much lower than the actuarial liability in the full funding limit, and the funding rules allowed plans to create surplus margins in their plans. Today, however, the full funding limit (FFL) can be less than the unfunded current liability for some plans (e.g., hourly plans which cannot project benefits). This makes it difficult for those plan sponsors to create a surplus to get through difficult times. Employers may not have wanted to increase surpluses in the past due to the high reversion tax, but recent experience has taught them the value of having a surplus in their plan.

Specific suggestions:

- **Allow faster Amortization**: The funding rules could be simplified, strengthened, and made less volatile with one change – reduce the number of amortization periods. The funding rules found in the funding standard account (Section 412(b)) could use something less than the 20- and 30-year periods, but more than the 5-year period for experience gains and losses (which causes volatility). Accounting rules already require a shorter period for expensing, so sponsors may be ready for this change. Unfunded retiree liabilities and frequent benefit improvements could be amortized faster if desired, which would be a simpler and better way to handle mature plans than using a yield curve. This rule would also be closer to the rules for underfunded plans, but some additional smoothing may be needed to phase into them. Faster amortization would also address the concerns that PBGC has with large credit balances eliminating deficit reduction contribution.

- **Rewrite Funding "Standards":** ERISA introduced **minimum** funding standards intended to ensure solvency to pay benefits. Over time these became de facto fiduciary standards of behavior when greater contributions were obviously necessary. This unintended result flows from the idea of legal compliance as a safe harbor for judging fiduciary responsibility. While not a change that should be adopted lightly, perhaps the detail of annual funding should be left to the plan sponsors with the government's role focusing on plan solvency. Because such a change would require time for study and debate the amortization changes would still be required as an interim measure.

Funding – Changing the Tax-Deductible Contribution Maximum

Our pension funding rules create volatile contribution patterns and discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong – and require substantial contributions when the economy declines and plan sponsors can least afford them. As news reports have noted, a number of companies in a wide variety of industries now find that their survival is threatened by the cash contribution requirements of pension plans that were reasonably well funded just a few years ago.

In the 1990s, a number of companies might have contributed to their well-funded pension plans, but could not because a contribution

(1) would not have been deductible,
(2) would have resulted in an excise tax, and
(3) would have created an inaccessible surplus that could not be used for other purposes if it was unneeded by the plan.

Not only were employers restricted from making contributions in past years but also, unfortunately, many became accustomed to the contribution holidays. Now, they have to contribute unusually large amounts to their newly underfunded pension plans. As I mentioned earlier, declines in the stock market and unusually low interest rates left many plans underfunded and triggered the deficit reduction contribution rule. (The chart, *Allow Contributions in Good Years,* at the end of this paper shows this graphically.) This dramatic economic change has made it difficult for many companies to come up with the necessary funds. Some firms responded by deciding to freeze and/or terminate their defined benefit

plans. Others find themselves in bankruptcy, unable to support their pension plans and looking to the PBGC for benefit guarantees.

Expanding current contribution limits would reduce this volatility. Ironically, a number of plan sponsors who would have liked to shore up their pension funding (and thus their balance sheets) by contributing their unfunded accumulated benefit obligation (ABO) at the end of 2001 and 2002 were unable to do so. If employers had been allowed to make deductible contributions, some would have done so in order to avoid the difficulties they are experiencing today, and pension plans (as well as the PBGC) would have been in better shape financially. Going forward, employers are now much more keenly aware of the risk of declining funding levels, and many would be interested in taking advantage of changes in the law that would allow them to build larger funding "cushions" against this risk.

Suggested remedies:

Increase the tax-deductible contribution maximum

Contributions are not deductible, and are subject to a 10 percent excise tax, when plan assets exceed currently defined maximum tax-deductible limits. Congress has addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability – but even this has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When interest rates were higher, the full funding limit provided a more generous margin above currernt liability, at least for pay-related plans, which have the ability to project future compensation increases when calculating the limit. However, when current interest rates are low,[3] the deductible limit provides little or no margin for adverse fluctuations in assets or liabilities – and, in many cases, as discussed later in this paper, does not even include liabilities for benefits the plan is committed to provide. Over the past three years, we have seen a large decline in the funded status of plans – both because the market value of plan investments has fallen, and because liabilities have increased due to lower discount rates. The significance of this decline depends on whether the changes are transitory or permanent.

Thus, we suggest policymakers consider allowing sponsors to deduct contributions until the plan is funded to some higher amount such as 130 percent of current liability (without smoothing of interest rates or asset values).[4] This 30 percent margin would have covered all but two periods in the last 100 years: the depression years (dramatic decreases in stock prices) and the past two years (dramatic decreases in stock prices and decreases in interest rates). If policymakers want the margin to cover a period that resembles the past two years, then approximately 165 percent or more might be needed.[5] If

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[3] For hourly plans (and plans with a large proportion of retirees), the full funding limit will generally be less than termination liability (TL) (because they cannot project benefit improvements), so they have no margin for adverse fluctuations. These are the very plans that are more likely to be underfunded now.

[4] This can be accomplished by replacing the words "current liability" with the words "130 percent of current liability" in §§404(a)(1)(D) and 404(a)(7)(A), and defining it using the current interest rates, not smoothed ones.

[5] What should this margin be? A frozen plan funded to 100 percent of TL, would be only 65 percent funded if stocks fell 50 percent (as they did over the 2-year period from the mid-2000 to mid-2002). We assumed the plan has the typical 70 percent of assets in stocks. If in addition, interest rates were to decrease by 1 percent (as they did during the same time period), then the funding ratio would be only 61 percent. This calculation assumes that 35 percent of plan assets in bonds have the same duration as the plan liabilities. If they are of shorter duration, then the funding ratio would be lower than 61 percent. A plan

the plan had shutdown benefits, an additional margin could be added equal to the present value of additional benefits as if shutdown benefits were triggered on the valuation date.

However, we recognize the need to balance concerns about pension security with concerns about the revenue impact; to address this perhaps a percentage lower than 165 percent could be used or the use of a larger margin could be restricted (to plans covered under Title IV of ERISA, for example). Other ways to improve funding are described in the following sections. In addition, we note that revenue losses may not be as great as might appear, since if a plan sponsor takes advantage of this provision now, smaller contributions would be possible in future years.

It is also important to recognize that the tax impact of DB plans is to defer, not exempt, funds from taxation. Amounts not taxable in a current year are taxable to a plan sponsor or plan participant in the future.

Allow deduction to reflect increases in unfunded liability at year-end

Many companies contributed (or would have liked to contribute) an amount to fully fund their liabilities at year-end, in order to improve the plan's funded position and possibly improve their corporate balance sheet. This contribution helps participants and the PBGC, and makes the pension plan 100 percent funded (on this basis), which should be encouraged. However, such a contribution may not be deductible under existing regulations. The unfunded liability at year-end can be larger than the unfunded CL used to determine the maximum tax-deductible contribution, because the latter does not include several items that can increase the unfunded liability during the year:

(1) Any asset losses that occur during the year
(2) Adverse changes in the interest rate used to calculate current liability
(3) Benefit improvements that are not included in the current valuation because they are adopted or become effective after the valuation date.
(4) Any increase in liability due to the government-required subsidy in lump sums or to future increases expected in federal benefit and compensation limits, which CL is prohibited from including.

We suggest that, as an alternative, employers be permitted to recalculate the maximum tax-deductible contributions for a year based on estimated year-end unfunded current liability. This could be done using actual year-end market values and current liability adjusted to reflect the approximate effects of changes in the current liability interest rate and other changes -- perhaps using the same principles as currently applied to adjust liabilities for PBGC variable rate premiums to reflect "significant events."

Allow deduction up to the amount that will eliminate the PBGC variable rate premium

Similarly, employers may wish to fund the amount necessary to eliminate the PBGC variable rate premium for the following year.

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funded to 130 percent of TL, would similarly become only 79 percent funded. A plan funded to 165 percent of TL would become 100 percent funded.

One way to exempt a plan from the variable rate premium is to fund an amount up to the full-funding limit for the prior year. If the plan's full-funding limit is based on the Retirement Protection Act of 1994 (RPA'94) override, the sponsor can deduct the necessary amount under current rules — a contribution up to 100 percent of current liability is deductible, and the RPA'94 full-funding limit is based on only 90 percent of current liability. However, if the Omnibus Reconciliation Act of 1987 (OBRA '87) limit or the actuarial accrued liability under the plan's funding method drives the plan's full-funding limit, current rules may not permit the deduction of the amount necessary to eliminate the variable rate premium.

We believe the additional security of a better-funded plan is more valuable than the additional premium dollars for the employer, the participants, and the PBGC.

Eliminate 25 percent restriction on combined defined contribution/defined benefit deductions

Current law restricts the deductible contribution for defined contribution plans if the combined contribution for defined benefit and defined contribution plans exceeds 25 percent of covered payroll. This is yet another impediment for employers who would like to strengthen the funding of their defined benefit plans, although Congress has partially addressed this by at least limiting the situations in which the 10 percent excise tax applies. If the 25 percent restriction could be eliminated with respect to tax deductions or at least with respect to the 10 percent excise tax, employers could contribute additional amounts to the defined benefit plan without jeopardizing contributions for defined contribution plans.

Allow all negotiated benefits to be reflected for bargained plans

It is generally believed that bargained plans are not as well funded as other plans. The reasons for this are arguable, but one is the effect of federal rules for both minimum and maximum funding purposes which do not permit future benefit improvements (even those that have already been negotiated) to be recognized in the calculations. This gives national sanction to ignoring unearned, yet probable, benefit liabilities in current funding decisions. By comparison, federal rules for salary based benefits require the use of a salary increase assumption in the funding calculations to project future benefit increases, although these projected benefits are not yet accrued (or earned) as of the current calculation date. The negotiated benefit improvements are reflected in the basic ERISA liabilities for the plan – but the corresponding increase in liability is amortized over the next 30 years. New improvements are likely at the end of the current labor agreement in three to five years. Thus, these plans are always behind in funding.

One partial approach would be to allow current liability to include the cost of benefit improvements already negotiated but scheduled to take effect in the future. This would allow the plan sponsor to reflect the cost of the full commitment to employees in their contribution levels, so that they could secure these benefits without continually falling behind as new levels of benefits are negotiated.

Multiemployer Plans

Proposals to allow deductions up to 130 percent of accrued liabilities would also be very important for multiemployer plans because their contributions are generally fixed for the length of the bargaining period. If asset returns are unusually good (like in the 1990s), the assets could easily exceed the full

funding limit for these plans (which, as discussed earlier, cannot include future amendments increasing benefits). This will cause the fixed contributions to not be deductible (and subject them to an excise tax). To alleviate this problem, multiemployer plans increased benefits (sometimes to surprisingly high amounts) in order to make the contributions deductible. With the recent fall in asset values, they now have the opposite problem. The fixed contribution is now less than the minimum required contribution, which will subject them to a 5 percent excise tax, and eventually a 100 percent excise tax. However, since accrued benefits cannot be cut, it can be difficult – if not impossible – to fix this problem. The best solution is not to induce companies to handicap themselves with unneeded benefit increases when assets do well. Allowing deductions up to 130 percent of current liability in IRC 404(a)(1)(D) (or allowing the projection of future benefit increases) for multiemployer plans could generally resolve this concern.

Reflect lump sum payments in current liability

Plans that offer voluntary lump sum payments must provide them using the subsidized interest rates required under IRC Section 417(e). These interest rates can dramatically increase the liability associated with these pension benefits, and employers cannot avoid this liability (at least for already-accrued benefits) by amending lump sum benefits out of the plan without violating anti-cutback rules.

However, even though they are committed to providing these benefits once they are in the plan, employers are not permitted to reflect the additional cost in current liability. This restricts their ability to contribute amounts needed to support the plan. We recommend inclusion of the full lump sum amount, at the very least for maximum deductible purposes, and preferably for all purposes.

Allow deduction for normal cost in all years

It might be helpful if employers could make a deductible contribution to the pension plan every year. That would avoid the recent problem of some employers no longer budgeting for contributions to their pension plan (because they were not deductible). What should this contribution be? Some actuaries have suggested that the aggregate method normal cost[6] (or open group normal cost) be deductible in all years. They note that one reason assets exceed actuarial liabilities at certain points in time is because asset returns have been better than expected. If assumptions are correct on average, then asset returns could be lower than expected at some point in the future. Given this dispersion of asset returns, the normal cost using an average interest rate may be appropriate every year. If necessary, a cap could be imposed on funding – e.g., the rules could specify that no contribution is deductible to the extent it results in assets greater than the total present value of benefits.

Graduate the normal cost

An alternative to the above suggestion would be to phase out the deductible contribution gradually, instead of eliminating it all at once. For example, a plan sponsor could deduct the normal cost minus the surplus divided by five. Thus, when the surplus is zero, the normal cost is deductible. When the surplus is five times the normal cost, it would be zero. This deduction rule would phase out between those two surplus amounts.

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[6] Plan sponsors could be permitted to use the aggregate or open group method for their maximum contribution in any year, without getting approval from the IRS.

If this general approach is acceptable, policymakers in the U.S. could adjust the actual mechanics, if desired. For example, the threshold for determining surplus could be 130 percent of current liability (or the FFL if greater) and/or the phase-out period could be extended to 10 years.

Allow or Mandate?

Some policymakers may suggest that underfunded plans should be required to contribute more. To minimize controversy over enactment we suggest the changes to the rules for *allowable* deductions but not the contribution *requirements*.

There are now strong incentives for companies to contribute more. For example, if assets fall below the accumulated benefit obligation, there can be adverse implications for the employer's corporate balance sheet. If assets fall below the liability for vested benefits, companies must pay an additional premium to the PBGC. If assets fall below 90 percent of current liability, contributions can increase dramatically. Recent drops in the market have provided a good reason for employers to increase their funding margins and build a "cushion" to protect against adverse experience.

A list of the underfunding penalties follows. If policymakers want to increase the incentives for funding, then a threshold for any one or more of the penalties could be increased (e.g., the threshold for security).

If the funding ratio falls below*	Then
125 %	No §420 transfer to the company post-retirement health plan Company cannot use the prior year valuation
110 %	Restrictions on the size of lump sums to the top 25
100 %	Accounting rules may force a hit to net worth PBGC variable premiums are payable Companies must pay quarterly contributions PBGC files lien on company if missed contributions > $1 M PBGC financial filings required if underfunded over $ 50 M Must report certain corporate transactions to PBGC if underfunded Bankrupt firms cannot increase benefits
90 %	Additional deficit reduction contributions required Notice to employees with funding ratio & PBGC guarantees required
60 %	Security required for plan amendments

*Note that the above ratios are based on varying measures of liability

Funding – Addressing Withdrawals

Incentives for employers to increase their funding margins may not work unless we also address the one-sided nature of the funding equation – employers who try to protect the plan by making additional contributions have very little opportunity to use those contributions if it later turns out that they weren't needed. For example, if an employer contributes enough to increase a plan's funding ratio to 130

percent, and then the stock market does very well, the plan may become so overfunded that the pension plan will never need all the assets.

If the employer needs some of the surplus pension money, it has few options other than terminating the pension plan. Not only is this a difficult, complex process that disturbs employees, but 85 percent of the margin would have to go to the federal government and even more would be paid in the form of state and local taxes, leaving very little for the plan sponsor who funded the plan.

One suggestion would be to only allow the reversion if:

- Assets exceed some high threshold (e.g., 150 percent of current liability, or the FFL limit if greater), and
- The uses of the reversion could be restricted to employee benefit plans.

If the above two requirements are met, the withdrawal could be subject not to the excise tax, but to the maximum corporate tax rate alone, regardless of current tax status, in order to make it a neutral element in the decision of whether to overfund.

In addition, the excise tax for reversions (and other withdrawals when assets exceed the above threshold) could be defined as that amount that eliminates the tax shelter on the withdrawal (based on some assumption as to how long the surplus was in the plan). This percentage should be much lower than the current 20 percent and 50 percent excise tax rates, due to the much lower tax rates on dividends just enacted this year.

Solvency - PBGC Concerns

We suggest that the provisions of the IRC Section 412(l) [Deficit Reduction Contributions], other laws and regulations, as well as the activities of the PBGC, can best be described as issues of plan solvency. The appropriate discount rate for IRC Section 412(l) is fundamental in assessing the adequacy of funding. Solvency has become a critical issue because of the decline in assets coupled with the decline in the discount rate, which is used to measure liabilities to determine funded status and potential requirement of deficit reduction contributions.

The PBGC and the plan participants are the primary stakeholders when it comes to plan solvency. They both focus on the plan sponsor's ability to meet the plan's obligations to the employees, especially in the case of plan termination. The need to find an appropriate discount rate replacement for the 30-year Treasury rate is specifically an issue of solvency, since the discount rate helps determine a plan's funding ratio and whether a deficit reduction contribution is required.

Due to the triple whammy of plummeting stock prices, lower interest rates, and the confluence of economic events that has raised the risk and number of bankruptcies, the PBGC balance sheet went from a surplus of $10 billion just two years ago to about a $5.7 billion deficit (unaudited for July 2003). However, the dollar amount of the deficit may not be as relevant as the funding ratio, which is 90 percent. Each time the PBGC takes over a pension plan, it also takes over the plan assets. PBGC's assets are now over $31.5 billion[7] while its annual outgo is expected to be around $3 billion. Thus, the PBGC

[7] This $31.5 billion amount includes the $6 billion in assets from probable plans in PBGC's FY 2002 annual report (such as Bethlehem Steel), because PBGC includes such liabilities in the report.

likely will not have problems fulfilling its primary mission for a number of years — to pay guaranteed benefits on time. This is not to say that we do not need a change in the funding rules. On the contrary, the Academy has already met with the PBGC to discuss ways to fix them. We are just saying that PBGC's large asset base allows time to thoroughly examine various alternatives to fix the funding rules before enacting them.

This discussion so far has only taken into account PBGC's past terminations. However, PBGC's financial status is also intimately linked with how industries (like the airline industry) fare over the next several years. The pension underfunding at several weak airlines exceeds $10 billion. In fact, PBGC's 2002 Annual Report forecasts that future claims could be twice the average of past claims — a clear signal that the PBGC may want to increase premiums and/or tighten funding rules.

Solvency – Fixing the Discount Rate

There is an urgent need to fix the discount rate, which is currently based on 30-year Treasury rate. This is an important issue that needs urgent attention, as various groups are discussing a number of alternatives, and it appears that Congress may make a decision in the near future. This rate is used for the determination of cash contributions, variable rate PBGC premiums, and other key pension calculations. Current law defines this interest rate in terms of 30-year Treasury bonds; these rates have been artificially depressed, significantly raising the currently measured costs associated with pension plans.

The discontinuance of 30-year Treasury bonds caused the laws of supply and demand to increase their price, reducing the rate. In addition, when the Federal Reserve Board (FRB) dramatically reduced lending rates, it brought interest rates down to historic lows.[8] The 30-year Treasury rate was adopted as a benchmark to approximate the annuity purchase rate; today it falls well below the current trend. The chart of discount rates at the end of this testimony shows that the maximum permissible rate was less than an annuity pricing rate in 2000 and 2001, and the rate would have been lower in 2002, if it were not for the temporary fix that Congress passed last year.

Without an adequate permanent replacement rate, some employers are forced to use drastic measures when addressing the future uncertainty of the funding obligation. While I have seen no statistics on the number of plan sponsors who have already frozen their plans to future accruals, many pension actuaries have clients who have frozen their plans and others that will be forced to freeze accruals in the future if they cannot adequately project reasonable future funding obligations.

The current version of the *Pension Preservation and Savings Expansion Act of 2003* includes the recommended use of a high-quality, long-term corporate bond rate. This legislation has the support of employers and labor, and we find it to be a more realistic and reliable measure to benchmark the true cost of annuities in the market. The bill also retains the use of a rate within the permissible range. While we do not take a position on the specific endpoints, a range is also appropriate because it allows for contribution flexibility.

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[8] Some argue the FRB actions have little effect on long rates. This is why the current yield curve is steep; FRB has driven down short rates with lesser impact on long rates.

Some groups have proposed the introduction of a full yield curve, which would mean that each individual pension plan would be valued using a different interest rate. While the valuation software of most major actuarial firms can accommodate these calculations, this method would increase the complexity and cost of the annual pension valuation, with relatively little change in the results, even though the current yield curve is relatively steep. If the yield curve returns to historical patterns, the effect of adding this complexity would be even less noticeable.

Furthermore, if it is decided to introduce the apparent degree of precision that is inherent in using a yield curve for assumed interest rates, it seems appropriate to reflect differences in mortality rates as well. In many cases, moving away from the current "one-size-fits-all" requirement – in particular, introducing "blue"- versus "white"-collar mortality rates and generational mortality projections – could essentially negate the effect of incorporating the interest rate yield curve.

Another issue policymakers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount rate in accordance with Congress's earlier intentions (something close to a corporate bond rate or annuity pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans (hopefully while the economy recovers). This could mean that fewer plans will need to be trusteed by the PBGC, and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer-based retirement programs.

Recommendations

The replacement benchmark of high-grade, long-term corporate bonds is a reasonable proposal consistent with the intended measurement. However, while the various funding issues are studied, the period of temporary enactment should be five years rather than two or three years, as proposed by the Administration and others. A longer period will provide a higher degree of certainty for employers, allowing them to make longer-term commitments and to develop appropriate funding policies to fit their business plans.

The drafters of the OBRA '87, that provided for the measurement of funded status and mandated funding escalation, could not have anticipated today's environment. They could not have anticipated the Treasury's decision to stop issuing 30-year bonds, nor could the rules have been prudently developed to anticipate an investment market like the one we've experienced over the past three years. During that time, plan sponsors have faced the additional challenge of grappling with a complex set of rules that identify solvency concerns and require higher funding levels. The net result is an increase in funding volatility for companies, some of whom have funded their plans to the maximum allowable by law throughout the 1990s. The combined market conditions place many very well funded plans in a position of having to make dramatically increased contributions immediately or in the near future while attempting to responsibly determine the future viability of their plans.

We need a system that is straightforward and predictable. There could be three types of measures: one that reflects a decline in funded status due to economic changes such as declining interest rates and markets; another that reflects a decline due to business practice relating to the sponsor's degree of responsibility for meeting its obligation to fund plan benefits; and a third that reflects a measure of the

risk a plan is subject to because of provisions like lump sum options, subsidized early retirement, and shut down benefits. Using methods similar to those for evaluating gains and losses in assessing funding experience against assumptions, the source of funded status decline can be determined with different remedies provided, based on the cause. This approach, along with some facts and circumstance provisions for plans that experience extreme changes, would allow companies that can demonstrate their ability to meet long-range obligations the opportunity to apply more gradual contribution increases.

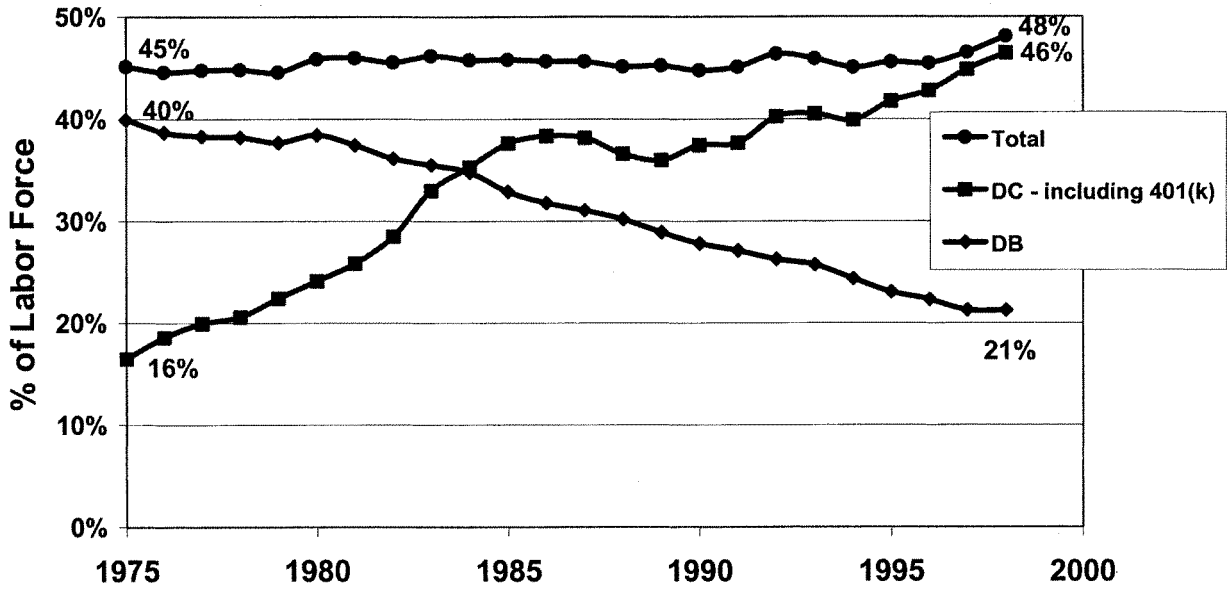
Accounting

The third factor is accounting, which should remain outside the scope of legislation. The stakeholders are owners of the company, analysts, and Securities and Exchange Commission (SEC) shareholder lenders. Their focus is to accurately assess the impact the DB plan has on business. Changes in the perspective on how DB plans should be reflected on a corporation's balance sheet have been significant and will likely continue to reflect the emerging view of higher transparency of accounting and measuring the obligation in the near future. There should continue to be a dividing line between the valuation of a DB plan obligation for assessing the financial status of a company and the valuation of the DB as a long-term contract with employees for funding and solvency. It is important that measures to address solvency and funding do not get confused with the accounting treatment of DB plans. Techniques such as the use of a bond yield curve can be defended as providing a more accurate value of the liability based on a plan's projected cash flows. This level of spot rate accuracy may be important in a market assessment environment, but may not necessarily provide the type of information for sound long-term decisions when it comes to cash requirements and funding policy.

Final Remarks

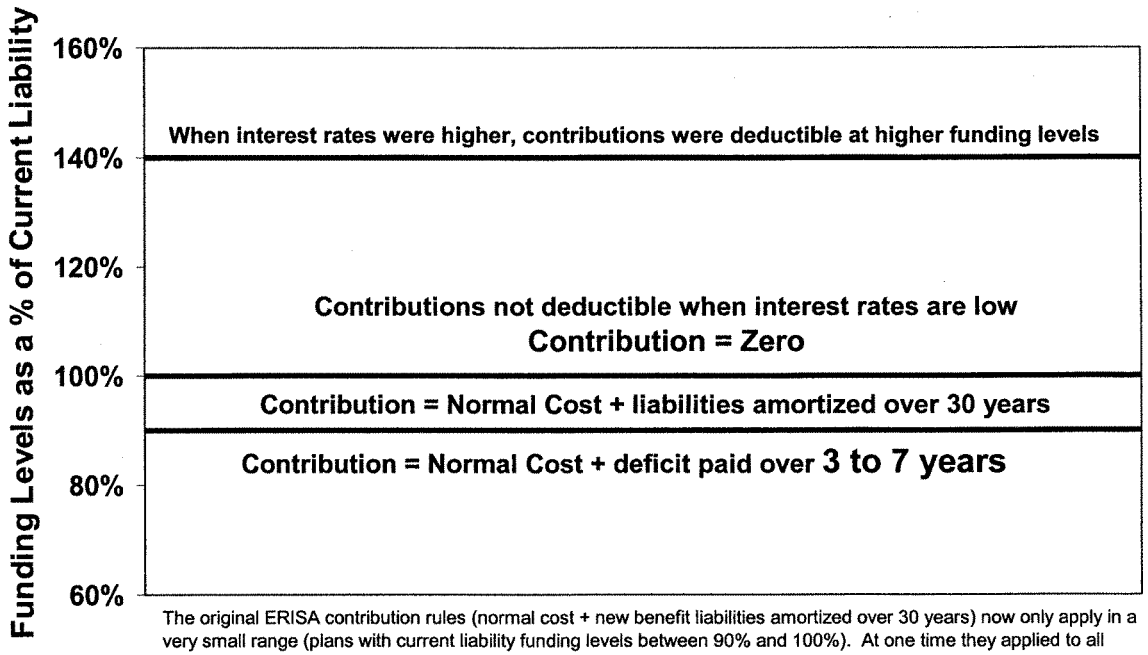
Defined benefit plans, once the most common form of retirement security for America's workers, have lost much of their attraction for corporations. The complicated solvency rules after three years of low interest rates and market returns have created a funding crisis for DB plans. At the same time, plan participants are starting to appreciate the value of being covered by a DB plan. Employees are beginning to recognize the value of the commitment and insurance element of pooling both investment risk and mortality risk through a company-sponsored plan. As a nation, we need to be equally concerned about the significant future number of retirees who may only have account balances to rely on to supplement Social Security benefits at retirement. The high risk of personal ruin through individual self-annuitization is yet to be fully realized.

Chart I - Participation Rates in Pension Plans (by type)



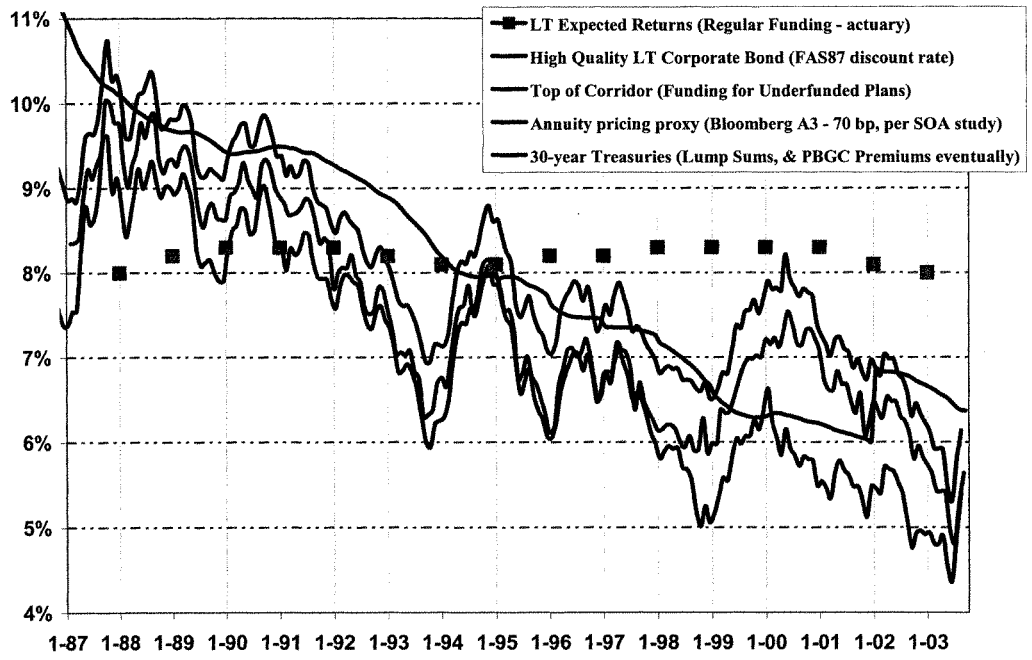
About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both. Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

Allow Contributions in Good Years



The original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). At one time they applied to all plans. The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. The expected returns are from Watson Wyatt surveys.

Testimony of J. Mark Iwry[1]

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

September 15, 2003

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

I. Background

A. Defined Benefit Plans and the PBGC

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

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

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

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

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

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

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

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

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

B. Taxpayers' Current Investment in Private Pensions

It is often observed that if the defined benefit pension funding problem becomes severe enough, PBGC might eventually become unable to pay insured benefits

as they come due, and a federal taxpayer bailout might be necessary. By way of context, it is worth recalling that the taxpayers already are partially subsidizing the private pension system, including defined benefit plans, through federal tax preferences for pensions.

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

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

II. Recent Developments Affecting Pension Funding and Pension Insurance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Guiding Principles to be Reconciled in Formulating Policy

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

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

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

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

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

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

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

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

IV. Threshold Questions

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

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

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

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

V. Specific Cautions and Considerations

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

A. Plan Sponsors Need Protection from Funding Volatility

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

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

B. Avoid Penalizing the Plan Sponsors That Are Funding Adequately

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

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

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

C. Improve Transparency and Disclosure of Underfunding

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

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

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

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

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

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

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

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

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

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

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

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

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[11] Combs testimony, pages 6-7.

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

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

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

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

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

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

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

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

E. Allow Funding to Take Into Account Expected Lump Sum Benefits

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

F. Beware of Unduly Restricting the Size of Benefit Payments in the Interest of Funding Relief

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

Congress could respond to further developments and experience affecting plan funding by revisiting and readjusting the discount rate and related rules, and

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

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

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

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

H. Be Cautious of Piecemeal Reforms

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

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

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

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

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

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A Somewhat Personal Note

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

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

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

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

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

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

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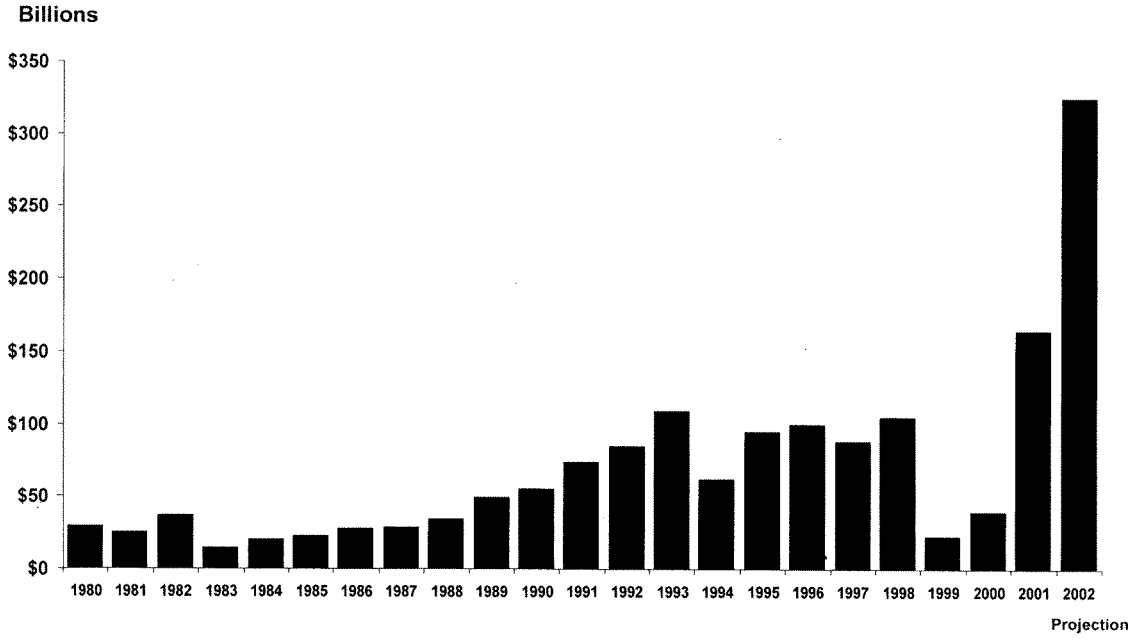
Mr. Chairman and Senator Akaka, I would be pleased to respond to any questions you and the Members of the Subcommittee might have.

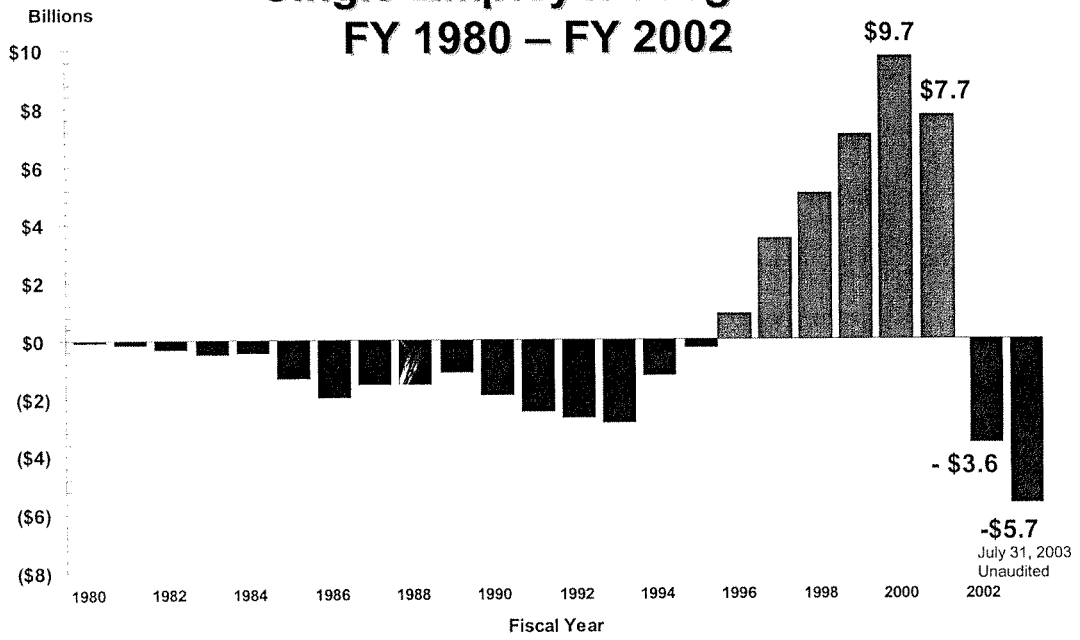
Total Underfunding

Insured Single-Employer Plans



PBGC estimates from Form 5500 and Section 4010 Filings

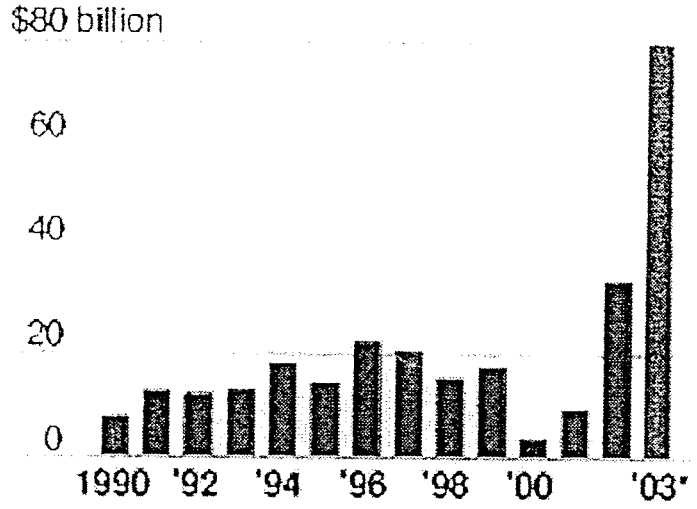
PBGC Net Position
Single-Employer Program
FY 1980 – FY 2002



Data does not include restored LTV plans in 1986

UNCERTAIN FUTURES

Underfunded pension-plan liabilities of financially weak companies have soared in recent years.



Source: Pension Benefit Guaranty Corp. *Estimate

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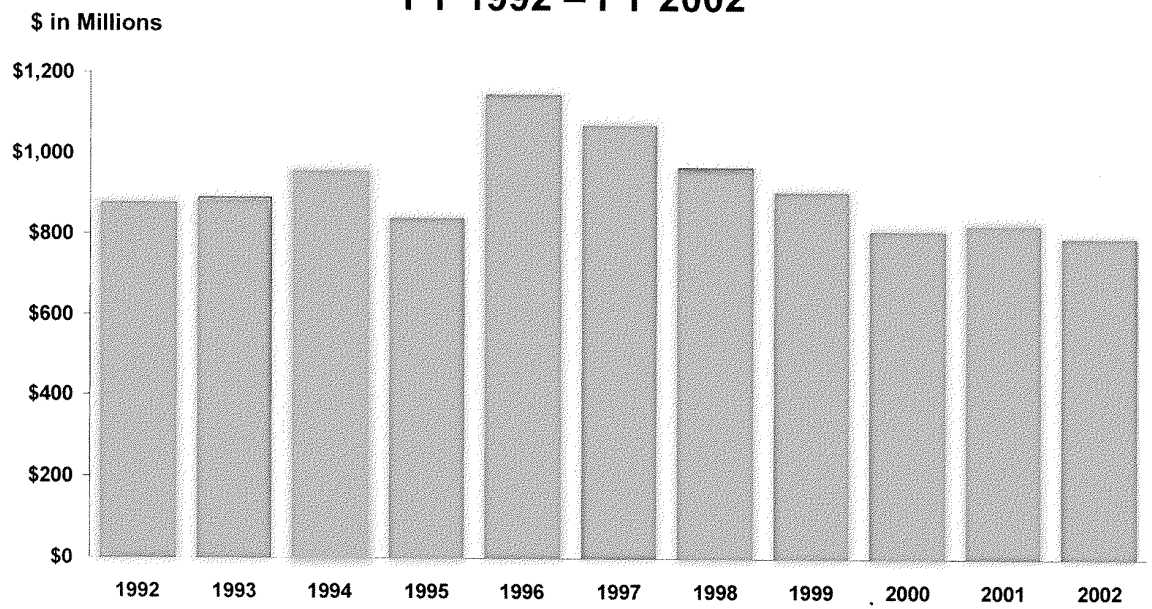
Single-Employer Premium Income

FY 1992 – FY 2002



NOTE: The variable rate premium was capped until 1996