THE PENSION UNDERFUNDING CRISIS: HOW EFFECTIVE HAVE REFORMS BEEN?

HEARING

BEFORE THE

COMMITTEE ON EDUCATION AND THE WORKFORCE U.S. HOUSE OF REPRESENTATIVES

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Wednesday, October 29, 2003
U.S. House of Representatives
Committee on Education and the Workforce
Washington, DC

The Committee met, pursuant to notice, at 10:30 a.m., in room 2175, Rayburn Building, Hon. John Boehner (Chairman of the Committee) presiding.

Present: Representatives Boehner, Petri, Ballenger, Hoekstra, Norwood, Ehlers, Tiberi, Gingrey, Burns, Miller, Owens, Payne, Andrews, Woolsey, Tierney, Wu, Holt, Majette, Van Hollen, and Ryan.

Staff present: Stacey Dion, Professional Staff Member; Christine Roth, Professional Staff Member; Chris Jacobs, Staff Assistant; Ed Gilroy, Director of Workforce Policy; Kevin Frank, Professional Staff Member; and Deborah L. Samantar, Clerk/Intern Coordinator.

Cheryl Johnson, Minority Counsel; Michele Varnhagen, Minority Labor Counsel/Coordinator; Mark Zuckerman, Minority General Counsel; and Margo Hennigan, Minority Legislative Assistant/Labor.

Chairman BOEHNER. We are here today to hear testimony on the pension underfunding crisis, and how effective have funding reforms been.

Under Committee rules, opening statements are limited to the Ranking Minority Member and the Chairman. Therefore, if other Members have opening statements, they will be included in the hearing record. And with that, I ask unanimous consent for the hearing record to remain open for 14 days, to allow Members' statements and other extraneous material referred to during the hearing this morning to be submitted for the official hearing record.

[No response.]

Chairman BOEHNER. Without objection, so ordered.

STATEMENT OF HON. JOHN A. BOEHNER, CHAIRMAN, COMMITTEE ON EDUCATION AND THE WORKFORCE

Chairman BOEHNER. I would like to welcome everyone and thank our distinguished witnesses for coming to testify on this very important subject. We take the issue of strengthening the pension security of American workers very seriously at this Committee, and it is a top priority for this Congress.

Our hearing today is the fourth in a series held by our Committee that examines the future of defined benefit pension plans.

As we all know, a perfect storm of historically low interest rates, the stock market decline of recent years, and an increasing number of retirees has led to a pension underfunding crisis that is threatening the future of the defined benefit pension system.

While this is not the first time we have seen significant pension underfunding problems, we have not faced a dilemma with the severity as the one we are currently facing. There is a sense of urgency to this underfunding crisis because of the growing consensus that it is putting the pension benefits of American workers at risk.

This financial health of defined benefit plans, and the fellow agency that insures them, the Pension Benefit Guaranty Corporation, has been widely reported. The PBGC announced earlier this month that it has accumulated an $8.8 billion deficit, by far the largest in agency history.

On top of that, the number of employers offering defined benefit pension plans has declined from 112,000 in 1985 to just more than 40,000 last year. And more and more employers are freezing or terminating their plans, and either shifting to 401(k) defined contribution plans, or they stop offering pension plans for their workers all together.

Today's hearing will allow us to examine the effectiveness of Federal pension funding reforms over the last 20 years, whether those reforms have contributed to the current underfunding crisis among defined benefit pension plans, and their impact on the retirement security of working families.

Over the last 20 years, Congress has twice made significant reforms to the funding rules that require employers to set aside money to fund the benefits they promise when they offer defined benefit pension plans to their workers.

The 1987 Pension Protection Act and the 1994 Retirement Protection Act were intended to strengthen the defined benefit system and prevent pension underfunding by requiring employers to make additional contributions to the plan, or accelerating existing funding obligations.

However, there has been much debate about whether these reforms have been effective in preventing plan underfunding, and their impact on worker pension benefits. With that in mind, it's very important for us to ask some fundamental questions.

Do the current funding rules act to delay sufficient pension funding of worker benefits? Is current law inadequate to fully protect the pensions of American workers? And despite the measures that Congress put into place in 1987 and 1994, a pension underfunding crisis exists that is threatening the future of the defined benefit pension system. The PBGC's deficit is threatening the agency's ability to ensure the pension benefits of workers across the country.

And there is some $80 billion in unfunded pension benefits looming on the horizon among financially weak companies, pension benefits that may ultimately have to be paid by the PBGC or, quite possibly, even the taxpayers.

So, it is important to note that the issue of pension funding can sometimes be a Catch-22. Employers find they are hit with some substantial funding requirements when they can least afford them.

But current funding rules often limit their funding contributions during healthier economic times, when they could better fund their pension plans. And these are some of the questions we are going to want to look at today.

Now, this hearing will allow the Committee to examine the effectiveness of the pension funding reforms over the last 20 years, and consider what additional reforms are necessary to strengthen the defined benefit pension system. If we could achieve that goal, we would be providing employers with greater stability and certainty, and enhancing the retirement security of American workers who rely on the safe, secure benefits that defined benefit pension plans provide.

I am pleased to note that the House recently acted, on a bipartisan basis, to address this pension underfunding crisis in the short term by passing a 2-year pension funding fix, the Pension Funding Equity Act, by a vote of 397 to 2, on October the 8th. This bipartisan bill would strengthen defined benefit plans in the short term, while we carefully consider more permanent solutions to the underfunding problems that are putting the pension benefits of American working families at risk.

And I want to thank my colleagues on this Committee, Mr. Miller, Mr. Johnson, Mr. Andrews, and others, and our colleagues at the Ways and Means Committee, for all of their hard work in moving that bill through the Floor.

Clearly, we have got a lot of work to do in defining long-term solutions to these problems, so I am anxious to hear from our witnesses today, and I look forward to working with the Administration and my colleagues on this issue as we move ahead.

And with that, I would like to yield to my friend and Ranking Member today, Mr. Andrews.

[The prepared statement of Chairman Boehner follows:]

Statement of Hon. John A. Boehner, Chairman, Committee on Education and the Workforce

I'd like to welcome everyone and thank our distinguished witnesses for coming to testify on this very important subject. We take the issue of strengthening the pension security of American workers very seriously at this Committee, and it is a top priority for this Congress. Our hearing today is the fourth in a series held by the Education & the Workforce Committee that examines the future of defined benefit pension plans.

As we all know, a "perfect storm" of historically low interest rates, the stock market decline of recent years, and an increasing number of retirees has led to a pension underfunding crisis that is threatening the future of the defined benefit pension plan system.

While this is not the first time we have seen significant pension underfunding problems, we have not faced a dilemma with the severity as the one we currently face. There is a sense of urgency to this underfunding crisis because of a growing consensus that it is putting the pension benefits of American workers at risk.

This financial health of defined benefit plans and the federal agency that insures them, the Pension Benefit Guaranty Corporation, have been widely reported. The PBGC announced earlier this month that it has accumulated an $8.8 billion deficit, by far the largest in agency history.

On top of that, the number of employers offering defined benefit pension plans has declined from 112,000 in 1985 to just more than 30,000 last year, and more and more employers are freezing or terminating their plans and either shifting to 401(k) defined contribution plans or stopping offering pension plans to their workers altogether.

Today's hearing will allow us to examine the effectiveness of federal pension funding reforms over the last 20 years, whether those reforms have contributed to the current underfunding crisis among defined benefit pension plans, and their impact on the retirement security of working families.

Over the last 20 years, Congress has twice made significant reforms to the funding rules that require employers to set aside money to fund the benefits they promise when they offer defined benefit pension plans to their workers.

The 1987 Pension Protection Act and the 1994 Retirement Protection Act were intended to strengthen defined benefit system and prevent pension underfunding by requiring employers to make additional contributions to the plan or accelerating existing funding obligations.

However, there is much debate about whether these reforms have been effective in preventing plan underfunding and their impact on worker pension benefits. With that in mind it is very important for us to ask some fundamental questions: Do the current funding rules act to delay sufficient pension funding of worker benefits? Is current law inadequate to fully protect the pensions of American workers?

Despite the measures that Congress put into place in 1987 and 1994, a pension underfunding crisis exists that is threatening the future of the defined benefit system. The PBGC's deficit is threatening the agency's ability to insure the pension benefits of workers across the country, and there is some $80 billion in unfunded pension benefits looming on the horizon among financially weak companies—pension benefits that may ultimately have to be paid by the PBGC or even taxpayers.

It is important to note that the issue of pension funding can sometimes be a catch–22: Employers find that they are hit with substantial funding requirements when they can least afford them, but current funding rules often limit their funding contributions during healthier economic times when they could better fund their pension plans. These are some of the issues we want to take a look at.

This hearing will allow the Committee to examine the effectiveness of pension funding reforms over the last 20 years and consider what additional reforms are necessary to strengthen the defined benefit pension system. If we can achieve that goal, we will be providing employers with greater stability and certainty and enhancing the retirement security of American workers who rely on the safe and secure benefits that defined benefit pension plans provide.

I am pleased to note that the House recently acted on a bipartisan basis to address this pension underfunding crisis in the short-term by passing a two-year pension funding fix—the Pension Funding Equity Act—by a vote of 397–2 on October 8th. This bipartisan bill would strengthen defined benefit plans in the short term while we carefully consider more permanent solutions to the underfunding problems that are putting the pension benefits of working families at risk. I'd like to thank my friends Sam Johnson and George Miller for their work on this bill.

Clearly we have a lot of work to do to find long-term solutions to these problems, so I am anxious to hear from our witnesses today. I look forward to working with the administration and my colleagues on this issue as we move ahead.

STATEMENT OF ROBERT E. ANDREWS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. ANDREWS. Thank you, Mr. Chairman. Good morning. I extend regards of our friend and colleague, George Miller, the Ranking Member of the Full Committee, who is occupied with some other responsibilities this morning.

Obviously, George Miller has a deep and abiding interest in these issues. He thanks you for the work you did with him and with the Minority on the recent legislation, and I assure you of his continuing interest.

I wish the problem we were talking about this morning were cyclical. I wish that we had gone from a $10 billion surplus in the PBGC's coffers to a nearly $10 billion deficit because of a downturn in the business cycle. That would be troubling, but it would be understandable, and with some degree of confidence we could take the position that we would simply wait for the next upturn in the business cycle.

I am convinced, having reviewed the excellent work of the GAO—the characteristically excellent work of the GAO —that we have no such luck. We are confronted with a permanent and structural shift in the economy that is manifesting itself in many ways, and one of those ways is the deficit position of the PBGC.

Defined benefit plans, disproportionately, are sponsored by so-called "old economy," or industrial economy, employers. As that industrial economy shrinks—and we hope that shrinkage is not permanent or inexorable, but we can't predicate our policy on the assumption that it isn't permanent and inexorable—as we have lost 1 million manufacturing jobs in the last nearly 3 years in the country, we are seeing the manifestation of that in the PBGC. I do not see any scenario for the U.S. economy where the manufacturing sector and the number of sponsors of defined benefit plans (DB) is going to grow considerably in the future. I see a lot of scenarios under which the outlays of the PBGC are going to grow considerably in the future.

If this were simply a problem driven by income shortages of the PBGC attributable to lesser earnings on its investments, and smaller contributions because of unprofitable companies, then I think that we would be justified in waiting out the business cycle.

It would be an egregious mistake to wait. This is a problem that is going to get worse, not better. It requires us to confront the problem, to understand that we have to strike a very difficult and delicate balance between enhancing the revenues of the PBGC, and not suffocating the employers who maintain defined benefit plans.

It would be a cruel irony, indeed, if the solution that we purport to find to the PBGC deficit problem smothers the viable sponsors of defined benefit plans that remain. We have to find some way to give those DB plan sponsors the room and flexibility to grow and prosper, while at the same time recognizing that we do have a serious structural problem in the PBGC.

I have said a lot of theoretical words this morning. What this is really about is whether some future Congress and some future Administration is going to have to use taxpayer money to bail out the PBGC in order to meet its continuing pension obligations to pensioners.

I do not think there is anyone here on the Republican or Democratic side that would stand idly by as pensioners lose their monthly pension check. No one wants to see that happen, and I doubt very much that any Congress would let that happen.

But we all should be unified in our resolve to avoid going to the general treasury, to the taxpayers of the country, to make that promise a promise that is kept. So I approach this hearing this morning with a sense of grave understanding of the structural problems that we have, a sense of great interest in hearing from the panelists this morning as to how they think we should address that problem, and a certainty, Mr. Chairman, that should you and I be privileged to be members of future Congresses, that this is a problem that we will be addressing, that we just cannot wish this one away.

And I do commend the Chairman for his serious and concerted approach to solving it here this morning.

Chairman BOEHNER. Thank you, Mr. Andrews. We have got a distinguished panel of witnesses before us, and I would like to introduce them.

First, we will hear from Barbara Bovbjerg, who is the Director of Education, Workforce, and Income Security Issues for the U.S. General Accounting Office, overseeing work and retirement income policy issues, including Social Security, the PBGC, and Employment Benefit Security Administration of the Department of Labor.

Next we will have Robert Krinsky, who is the chairman of the Segal Company, which provides benefit and compensation consulting to corporations and non-profit organizations.

Michael Gordon is the General Counsel for the Retiree Legislative Action Network, here in Washington, which monitors safeguards for retired participants in ERISA health and pension plans.

Next, we will hear from Mark Iwry, a Non-Resident Senior Fellow with The Brookings Institution, here in Washington, who formerly served as Benefits Tax Counsel for the Treasury Department.

And then last, we will hear from David John, who is a Research Fellow at The Heritage Foundation and a former member of several commissions that examine ways to improve the Social Security program.

And before witnesses begin, I would like to remind Members we will be asking questions after the entire panel has testified, and under Committee rule (2), imposes a 5-minute limit on all questions. I think most of you have been here before, you know the timers.

With that, Ms. Bovbjerg, if you would like to begin, we are interested in what you have to say.

STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Ms. BOVBJERG. Thank you, Mr. Chairman, Members of the Committee. I appreciate your inviting me here today to discuss pension funding reform. As you know, underfunded plans sponsored by weak employers have drained the financial resources of the Pension Benefit Guaranty Corporation's single employer program, which is now $8.8 billion in deficit.

Minimum funding rules embedded in the tax code to help assure that pension plans have adequate assets did not prevent such plans from being severely underfunded, and thereby putting PBGC and insured workers and retirees alike at risk.

Today, Mr. Chairman, we are issuing the report you requested detailing the causes of PBGC's financial reversal, and outlining various approaches to address it. In the report, we call for a comprehensive policy response. Reforming the rules that regulate how sponsors fund their plans would be an essential part of that response. Indeed, you have invited me here to discuss options to improve defined benefit pension plans' funding rules.

My testimony today discusses two general approaches to funding reform. First, the variety of options that would change funding requirements directly, and second, the options that would strengthen plan funding through more indirect means. My testimony is based on information gathered from the PBGC, from interviews with pension experts, and our analysis of several individual plans that represented large losses.

First, the direct approaches. Several types of reforms to the funding rules might be considered. For example, the tax code could be amended to base funding requirements on plans' termination liabilities, which are based on the amount of cash required to close out a plan, rather than on current liabilities.

Basing funding requirements on termination liabilities would provide a more accurate funding target, should plans terminate, and would likely raise required contributions. The tax code could also be amended to alter the rules for requiring what is sometimes called the deficit reduction contribution, or DRC.

Currently, sponsors must make DRCs when plan assets are less than 80 percent of current liability, with some exceptions for plans with higher funding levels in the prior few years. In conditions where planned funding is rapidly worsening, some sponsors don't have to make additional contributions until subsequent years.

Altering this threshold would require more sponsors of underfunded plans to make DRCs on a more timely basis. Limiting the use of credit balances by severely underfunded plans could also help. Under current law, Bethlehem Steel used credit balances to avoid making cash contributions in 2000, 2001, and 2002, while its plan funding was, in fact, deteriorating rapidly. Limiting the use of such balances might prevent further deterioration of already underfunded plans.

Raising the level of tax-deductible contributions could also help maintain plan funding in a cyclical economic environment. The law restricts tax-deductible contributions to prevent plan sponsors from amassing tax deductions for contributions beyond what is necessary to cover future benefits.

In effect, the rules prevent employers from making larger contributions during periods of strong profitability, and thus strengthening plans against cyclical downturns. Any comprehensive funding reform should consider a change to these limitations.

There are other direct reforms outlined in my written statement, but let me now turn to the indirect approaches that could improve funding incentives.

PBGC variable rate premiums are intended to influence sponsor commitment to plan funding, because these premiums are based on the plan's level of underfunding. Keeping a plan funded permits a sponsor to avoid higher premiums.

However, Bethlehem Steel and other companies whose severely underfunded plans terminated most recently did not pay variable rate premiums, despite the underfunding. Clearly, these premiums are not much of a funding incentive, as currently structured, and improvements seem warranted. Variable-rate premiums could be restructured to better reflect the economic strength of the plan sponsor and other risks affecting plan health.

Improved transparency of plan and sponsor financial condition could help, as well. Greater disclosure of plan investments, benefit guarantees, and termination liabilities could better inform plan participants, and thus provide an incentive for sponsors to fund benefits they have promised. Better public information could be a relatively inexpensive but important aspect of any comprehensive reform.

In conclusion, widespread underfunding in the defined benefit pension system threatens not only the solvency of PBGC's largest program, it also threatens the retirement security of millions of American workers. The causes of this problem appear to extend beyond recent economic conditions and suggest that comprehensive reform is necessary to stabilize and enhance the long-term health of the DB system.

Truly meaningful reform will take a long-term perspective and will balance employer concerns with improvements to employer accountability for funding and reporting.

GAO is giving PBGC's single-employer program and its needs special scrutiny in the immediate future and will be pleased to help Congress develop effective strategies for such reform.

That concludes my statement, Mr. Chairman. I await your questions.

[The prepared statement of Ms. Bovbjerg follows:]

Statement of Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, U.S. General Accounting Office, Washington, DC

United States General Accounting Office

GAO

Testimony

Before the Committee on Education and the Workforce, House of Representatives

For Release on Delivery
Expected at 10:30 a.m. EST
Wednesday, October 29, 2003

PRIVATE PENSIONS

Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding

Statement of Barbara D. Bovbjerg, Director,
Education, Workforce, and Income Security Issues

G A O
Accountability * Integrity * Reliability

GAO-04-176T

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-04-176T, a report to the Committee on Education and the Workforce, House of Representatives

October 29, 2003

PRIVATE PENSIONS

Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding

Why GAO Did This Study

Over the last few years, the total underfunding in the defined-benefit pension system has deteriorated to the point where the Pension Benefit Guaranty Corporation (PBGC), the federal agency responsible for protecting private sector defined benefit plan benefits, estimates that total plan underfunding grew to more than $400 billion as of December 31, 2002, and still exceeded $350 billion as of September 4, 2003. PBGC itself faced an estimated $8.8 billion accumulated deficit as of August 31, 2003. Deficiencies in current funding and related regulations have contributed to several large plans recently terminating with severely underfunded pension plans.

This testimony provides GAO's observations on a variety of regulatory and legislative reforms that aim to improve plan funding and better protect the benefits of millions of American workers and retirees while minimizing the burden to plan sponsors of maintaining defined-benefit plans.

www.gao.gov/cgi-bin/getrpt?GAO-04-176T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbard D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

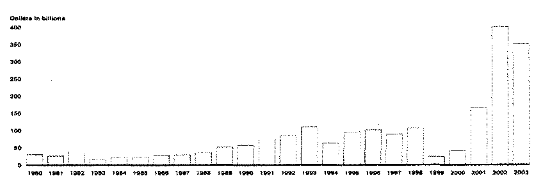
What GAO Found

Recent terminations of severely underfunded pension plans suggest that current funding rules do not provide adequate mechanisms for maintaining adequate funding of pension plans. Funding inadequacies place the retirement security of millions of American workers and retirees, along with PBGC, at risk. While external factors, such as falling stock prices, low interest rates, and slow economic growth, have contributed to widespread pension underfunding, the defined-benefit system also faces structural problems that extend beyond cyclical economic conditions. Stagnant growth of the defined-benefit system, along with several large recent terminations of underfunded pension plans, has left PBGC in a precarious financial condition as the insurer of pension benefits.

There are two general approaches to funding reform that may improve the funding of defined-benefit pension plans. The first approach would change the funding requirements directly. These measures could address reforms to the use of termination liability instead of current liability, additional funding requirements, and lump-sum distributions. The second, more indirect approach would seek to improve plan funding by providing better incentives for sponsors to keep their plans better funded. Options in this category could include requirements broadening the disclosure of plan investments and termination liability information to plan participants and their representatives. These reforms, as part of a comprehensive package, could increase the likelihood that workers and retirees receive promised benefits, while not creating an undue regulatory or financial burden on sponsors.

Recent unfavorable economic conditions have contributed to widespread underfunding and conspired to place well-meaning plan sponsors in difficult positions. Although comprehensive reform should include improving plan funding as the key vehicle to stabilize the long-term health of the defined-benefit system, Congress may seek to balance improvements in funding and accountability against the short-term needs of some sponsors who may have difficulty making plan contributions.

Figure 2: Total Underfunding in PBGC-Insured Single-Employer Plans, 1980-2003



Note: Figure for 2003 is an estimate, as of September 4, 2003.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss improving the funding of single-employer defined-benefit plans.[1] As all of you are aware, this is a crucial issue threatening the retirement security of millions of America's workers and retirees. Underfunded plans sponsored by weak or bankrupt employers have drained the financial resources of the Pension Benefit Guaranty Corporation (PBGC), the backstop federal agency that insures the benefits promised by these plan. PBGC's single-employer insurance program currently faces an estimated deficit of $8.8 billion as of August 31, 2003, following the largest 1-year loss in the agency's history. This deficit could likely increase during the next few years, with PBGC estimating that by the end of fiscal year 2003, total underfunding in financially troubled firms could exceed $80 billion.[2] We believe that an appropriate comprehensive policy response can stabilize the funding of these pension plans, thereby protecting workers' benefits for the foreseeable future. Reforming the rules that regulate how sponsors fund their pension plans is an essential part of this response. I hope my testimony will help clarify some of the key issues as the Congress and the relevant agencies choose how to respond to these serious financial challenges. As you requested, I will discuss some options to improve the funding status of defined-benefit plans.

[1]A defined-benefit plan promises a benefit that is generally based on an employee's salary and years of service. The employer is responsible for funding the benefit, investing and managing plan assets, and bearing the investment risk. In contrast, under a defined contribution plan, benefits are based on the contributions to and investment returns on individual accounts, and the employee bears the investment risk. There are two federal insurance programs for defined-benefit plans: one for single-employer plans and another for multiemployer plans. Our work was limited to the PBGC program to insure the benefits promised by single-employer defined-benefit pension plans. Single-employer plans provide benefits to employees of one firm or, if plan terms are not collectively bargained, employees of several unrelated firms.

[2]According to PBGC, for example, companies whose credit quality is below investment grade sponsor a number of plans. PBGC classified such plans as reasonably possible terminations if the sponsors' financial condition and other factors did not indicate that termination of their plans was likely as of year-end. See *PBGC 2002 Annual Report*, p. 41. The independent accountants that audited PBGC's financial statement reported that PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable and reasonably possible plan terminations. According to an official, PBGC has implemented new procedures focused on improving these controls. See Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2002 and 2001 Financial Statements in PBGC *Office of Inspector General Audit Report*, 2003-3/23168-2 (Washington, D.C.: Jan. 30, 2003).

To identify the types of reform that may improve funding for defined-benefit (DB) pension plans, we reviewed proposals for reforming the single-employer program made by the Department of the Treasury, PBGC, and pension professionals. We also discussed with PBGC officials, and examined annual reports and other available information related to the funding and termination of three pension plans: the Anchor Glass Container Corporation Service Retirement Plan, the Pension Plan of Bethlehem Steel Corporation and Subsidiary Companies, and the Polaroid Pension Plan. We selected these plans because they represented the largest losses to PBGC in their respective industries in fiscal year 2002. PBGC estimates that, collectively, the plans represented over $4 billion in losses to the program at plan termination. At the request of this committee, we will release a report at the end of this month on the financial condition of the PBGC single-employer pension program and related issues of pension plan reform.

To summarize my responses, there are two general approaches to funding reform that may improve the funding of defined-benefit pension plans. The first approach would change the funding requirements directly. These measures could encompass reforms to the use of current and termination liability in plan funding calculations,[3] additional funding requirements, credit balances, unfunded benefits or benefit increases, and lump-sum distributions. The second, more indirect approach would seek to improve plan funding by providing better incentives for sponsors to keep their plans better funded. Options in this category could include requirements broadening the disclosure of plan investments and termination liability information to plan participants and their representatives, the restructuring of PBGC's variable-rate premium to incorporate risk factors other than the level of underfunding, and mairi ıg modifications to certain guaranteed benefits that could decrease losse ε incurred from underfunded plans. Reforms adopted to directly change the funding requirements or improve plan funding through providing incentives for sponsors are not mutually exclusive, and several variations exist within each reform option. These reforms, taken separately or in coordination, could increase the likelihood of plans receiving adequate funding to ensure that workers and retirees receive promised benefits.

[3] A plan's termination liability measures the value of accrued benefits using assumptions appropriate for a terminating plan, while its current liability measures the value of accrued benefits using assumptions specified in applicable laws and regulations.

Background

Before enactment of the Employee Retirement and Income Security Act (ERISA) of 1974, few rules governed the funding of defined-benefit pension plans, and participants had no guarantees that they would receive the benefits promised. When Studebaker's pension plan failed in the 1960s, for example, many plan participants lost their pensions.[4] Such experiences prompted the passage of ERISA to better protect the retirement savings of Americans covered by private pension plans. Along with other changes, ERISA established PBGC to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not.[5] ERISA also required PBGC to encourage the continuation and maintenance of voluntary private pension plans and to maintain premiums set by the corporation at the lowest level consistent with carrying out its obligations.[6]

Under ERISA, the termination of a single-employer defined-benefit plan results in an insurance claim with the single-employer program if the plan has insufficient assets to pay all benefits accrued under the plan up to the date of plan termination.[7] PBGC finances the unfunded liabilities of terminated plans partially through premiums paid by plan sponsors. Currently, plan sponsors pay a flat-rate premium of $19 per participant per year; in addition, some pay a variable-rate premium, which was added in

[4]The company and the union agreed to terminate the plan along the lines set out in the collective bargaining agreement: retirees and retirement-eligible employees over age 60 received full pensions, and vested employees under age 60 received a lump-sum payment worth about 15 percent of the value of their pensions. Employees whose benefit accruals had not vested, including all employees under age 40, received nothing. James A. Wooten, "The Most Glorious Story of Failure in Business:' The Studebaker–Packard Corporation and the Origins of ERISA." *Buffalo Law Review*, vol. 49 (Buffalo, NY: 2001): 731.

[5]Some defined-benefit plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.

[6]See section 4002(a) of P.L. 93-406, Sept. 2, 1974.

[7]The termination of a fully funded defined-benefit pension plan is termed a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company under which the insurance company agrees to pay all accrued benefits or by paying lump-sum benefits to participants if permissible. Terminating an underfunded plan is termed a distress termination if the plan sponsor requests the termination or an involuntary termination if PBGC initiates the termination. PBGC may institute proceedings to terminate a plan if, among other things, the plan will be unable to pay benefits when due or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a). PBGC may pay only a portion of the claim because ERISA places limits on PBGC's benefit guarantee.

1987 to provide an incentive for sponsors to better fund their plans. The variable-rate premium, which started at $6 for each $1,000 of unfunded vested benefits, was initially capped at $34 per participant. The variable rate was increased to $9 for each $1,000 of unfunded vested benefits starting in 1991, and the cap on variable-rate premiums was removed starting in 1996.

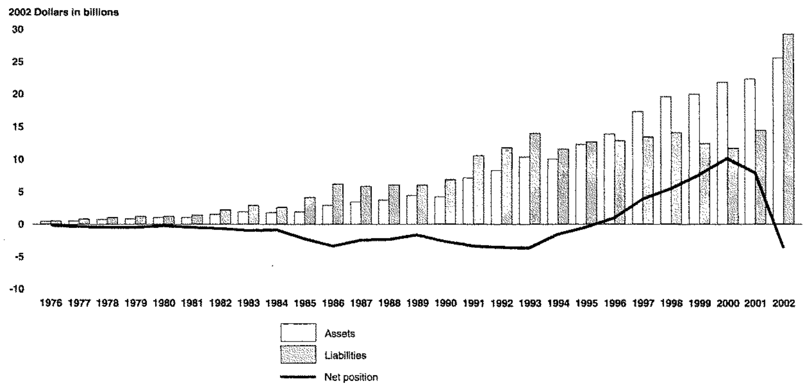
Following the enactment of ERISA, however, concerns were raised about the potential losses that PBGC might face from the termination of underfunded plans. To protect PBGC, ERISA was amended in 1986 to require that plan sponsors meet certain additional conditions before terminating an underfunded plan. For example, sponsors could voluntarily terminate their underfunded plans only if they were bankrupt or generally unable to pay their debts without the termination.

The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other liabilities—for much of its existence. (See fig. 1.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to about $10 billion, in 2002 dollars. However, the program's finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about $3.6 billion. PBGC estimates that this deficit grew to $8.8 billion by August 31, 2003, its largest deficit in the program's history both in real and nominal terms. From less than $50 billion as of December 31, 2000, the total underfunding in single-employer plans grew to more than $400 billion as of December 31, 2002, and still exceeds $350 billion according to recent estimates by PBGC. (See fig 2.) Despite the program's large deficit, according to a PBGC analysis, the single-employer program was estimated to have enough assets to pay benefits through 2019, given the program's conditions and PBGC assumptions as of the end of fiscal year 2002.[8] However, losses since that time may have shortened the period over which the program will be able to cover promised benefits. In July of this year, because of serious risks to

[8]The estimate assumes: (1) a rate of return on all PBGC assets of 5.8 percent and a discount rate on future benefits of 5.67 percent; (2) no premium income and no future claims beyond all plans with terminations that were deemed "probable" as of September 30, 2002; (3) administrative expenses of $225 million in fiscal year 2003, $229 million per year for fiscal years 2004-2014, and $0 thereafter; (4) mid-year termination for "probables"; and (5) that PBGC does not assume control of "probable" assets and future benefits until the date of plan termination.

the single-employer program's viability, we placed the PBGC on our high-risk list.[9]

Figure 1: Assets, Liabilities, and Net Position of the Single-Employer Pension Insurance Program, Fiscal Years 1976-2002

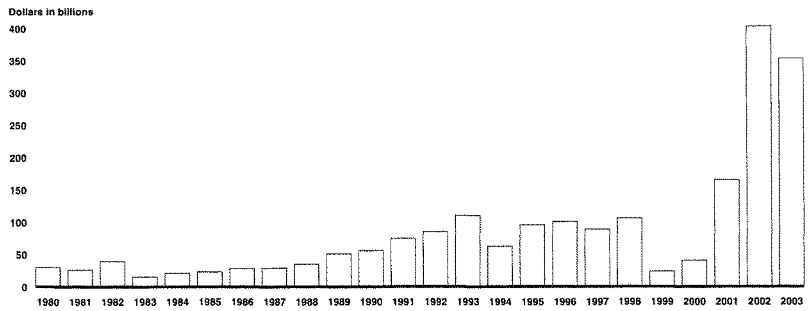


Source: PBGC annual reports.

Note: Amounts for 1986 do not include plans subsequently returned to a reorganized LTV Corporation. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

[9]See U.S. General Accounting Office, *Pension Benefit Guaranty Corporation Single-Employer Insurance Program: Long-Term Vulnerabilities Warrant "High Risk" Designation*, GAO-03-1050SP (Washington, D.C.: July 23, 2003).

Figure 2: Total Underfunding in PBGC-Insured Single-Employer Plans, 1980 - 2003



Source: PBGC.

Note: 2003 figure is an estimate, as of September 4, 2003.

For the most part, liabilities of the single-employer pension insurance program are comprised of the present value of insured participant benefits. PBGC calculates present values using interest rate factors that, along with a specified mortality table, reflect annuity prices, net of administrative expenses, obtained from surveys of insurance companies conducted by the American Council of Life Insurers.[10] In addition to the estimated total liabilities of underfunded plans that have actually terminated, PBGC includes in program liabilities the estimated unfunded liabilities of underfunded plans that it believes will probably terminate in the near future.[11] PBGC may classify an underfunded plan as a probable termination when, among other things, the plan's sponsor is in liquidation under federal or state bankruptcy laws.

[10]In 2002, PBGC used an interest rate factor of 5.70 percent for benefit payments through 2027 and a factor of 4.75 percent for benefit payments in the remaining years.

[11]Under Statement of Financial Accounting Standard Number 5, loss contingencies are classified as probable if the future event or events are likely to occur.

Several Factors Have Contributed to PBGC's Current Financial Difficulties

As we reported to this committee in September of this year,[12] several factors have contributed to PBGC's and plans' current financial difficulties. The financial condition of the single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. In 1992, we reported that many factors contributed to the degree plans were underfunded at termination, including the payment at termination of additional benefits, such as subsidized early retirement benefits, which have been promised to plan participants if plants or companies ceased operations.[13] These factors likely contributed to the degree that plans terminated in 2002 were underfunded. Factors that increased the severity of the plans' unfunded liability in 2002 were the recent sharp decline in the stock market and a general decline in interest rates.

In many cases, sponsors did not make the contributions necessary to adequately fund the plans before they were terminated. For example, according to annual reports (Annual Return/Report of Employee Benefit Plan, Form 5500) submitted by Bethlehem Steel Corporation, in the 7 years from 1992 to 1999, the Bethlehem Steel pension plan went from 86 percent funded to 97 percent funded. (See fig. 3.) From 1999 to plan termination in December 2002, however, plan funding fell to 45 percent as assets decreased and liabilities increased, and sponsor contributions were not sufficient to offset the changes. According to a survey,[14] the Bethlehem Steel defined-benefit plan had about 73 percent of its assets (about $4.3 billion of $6.1 billion) invested in domestic and foreign stocks on September 30, 2000. One year later, assets had decreased $1.5 billion, or 25 percent, and when the plan was terminated in December 2002, its assets had been reduced another 23 percent to about $3.5 billion—far less than needed to finance an estimated $7.2 billion in PBGC-guaranteed liabilities.[15] Surveys of plan investments by Greenwich Associates

[12] See U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-03-873T (Washington, D.C.: Sept. 4, 2003).

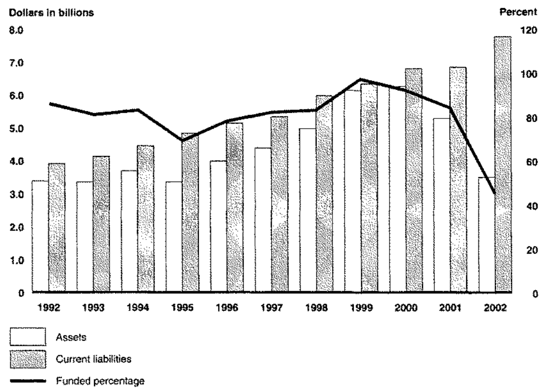
[13] See U.S. General Accounting Office, *Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Programs*, GAO/HRD-93-7 (Washington, D.C.: Dec. 30, 1992).

[14] Pensions & Investments, vol. 29, Issue 2 (Chicago: Jan. 22, 2001).

[15] According to the survey, the Bethlehem Steel Corporation's pension plan made benefit payments of $587 million between Sept. 30, 2000, and Sept. 30, 2001. Pensions and Investments, www.pionline.com/pension/pension.cfm (downloaded on June 13, 2003).

indicated that defined-benefit plans in general had about 62.8 percent of their assets invested in U.S. and international stocks in 1999.[16]

Figure 3: Assets, Liabilities, and Funded Status of the Bethlehem Steel Corporation Pension Plan, 1992-2002



Source: Annual Form 5500 reports and PBGC.

Note: Assets and liabilities for 1992 through 2001 are as of the beginning of the plan year. During that period, the interest rate Bethlehem Steel used to value current liabilities decreased from 9.26 percent to 6.21 percent. Assets and liabilities for 2002 are PBGC estimates at termination in December 2002. Termination liabilities were valued using a rate of 5 percent.

These recent events and their consequences for PBGC's finances have occurred in the context of the long-term stagnation of the defined-benefit system. The number of PBGC-insured plans has decreased steadily from approximately 110,000 in 1987 to around 30,000 in 2002.[17] While the number of total participants in PBGC-insured single-employer plans has grown approximately 25 percent since 1980, participation has declined as

[16]2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, Conn.

[17]In contrast, defined-contribution plans have grown significantly over a similar period—from 462,000 plans in 1985 to 674,000 plans in 1998.

a percentage of the private sector labor force. Further, the percentage of participants who are active workers has declined from 78 percent in 1980 to 53 percent in 2000. Manufacturing, a sector with virtually no job growth in the last half-century, accounted for almost half of PBGC's single-employer program participants in 2001, suggesting that the program needs to rely on other sectors for any growth in premium income. Unless something reverses these trends, PBGC may have a shrinking plan and participant base to support the program in the future as well as the likelihood of a participant base concentrated in certain, potentially more vulnerable industries.

Minimum Funding Rules Did Not Prevent Plans from Being Severely Underfunded

Internal Revenue Code (IRC) minimum funding rules, which are designed to ensure plan sponsors adequately fund their plans, did not have the desired effect for the terminated plans that were added to the single-employer program in 2002. The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years.[18] Also, the rules require the sponsor to make an additional contribution if the plan is underfunded to the extent defined in the law. Under the additional funding requirement rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year.[19]

In 1987, the minimum funding rules incorporated by ERISA in the IRC were amended to require that plan sponsors calculate each plan's current

[18]Minimum funding rules permit certain plan liabilities, such as past service liabilities, to be amortized over specified time periods. See 26 U.S.C. 412(b)(2)(B). Past service liabilities occur when benefits are granted for service before the plan was set up or when benefit increases after the set up date are made retroactive.

[19]See 26 U.S.C. 412(l)(9)(C).

liability, using a discount rate based on the 30-year Treasury bond rate, and to use that calculation to assess the plan's funding level.[20] If plans are funded below certain thresholds as defined in the IRC, employers are to determine minimum contribution amounts on the basis of those assessments. Employers must make additional contributions to the plan if it is underfunded to extent defined in the law.[21] If a plan is fully funded as defined in the law, employers are precluded from making additional tax-deductible contributions to the plan. In 2002, the Congress acted to provide temporary relief to DB plan sponsors by raising the top of the permissible range of the mandatory interest rate.[22] As discussed in a report we issued earlier this year,[23] concerns that the 30-year Treasury bond rate no longer resulted in reasonable current liability calculations has led both

[20]Under the IRC, current liability means all liabilities to employees and their beneficiaries under the plan. See 26 U.S.C. 412(l)(7)(A). In calculating current liabilities, the IRC requires plans to use an interest rate from within a permissible range of rates. See 26 U.S.C. 412(b)(5)(B). In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year beginning with the 1995 plan year to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The weighted average rate is calculated as the average yield over 48 months with rates for the most recent 12 months weighted by 4, the second most recent 12 months weighted by 3, the third most recent 12 months weighted by 2, and the fourth weighted by 1.

[21]Under the additional funding requirement rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(l)(9)(C).

[22]The top of the permissible range of the 30-year Treasury rate for determining a plan's current liability was temporarily increased to 20 percent above the weighted average rate for 2002 and 2003. This temporary measure expires at the end of 2003.

[23]See U.S. General Accounting Office, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations,* GAO-03-313 (Washington, D.C.: Feb. 27, 2003).

Congress and the administration to propose alternative rates for these calculations.[24]

While minimum-funding rules may encourage sponsors to better fund their plans, plans can earn funding credits, which can be used to offset minimum funding contributions in later years, by contributing more than required according to minimum funding rules. Therefore, sponsors of underfunded plans may avoid or reduce minimum funding contributions to the extent their plan has a credit balance in the account, referred to as the funding standard account, used by plans to track minimum funding contributions.[25]

Additionally, the rules require sponsors to assess plan funding using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities.[26] A plan's termination liability measures the value of accrued benefits using assumptions appropriate for a terminating plan, while its current liability measures the value of accrued benefits using assumptions specified in applicable laws and regulations. Current and termination liabilities differ because the assumptions used to calculate them differ. Interest rates are a key assumption in calculating the present value of future pension benefits: while all sponsors calculate current liabilities using a rate based on the 30-year Treasury bond rate, ERISA requires sponsors of some underfunded plans to report plan termination liability information to PBGC. These sponsors calculate termination liability using a rate published by PBGC, based on surveys of

[24]Recently, the U.S. House of Representatives passed the Pension Funding Equity Act (H.R. 3108), which replaces the 30-year Treasury rate with a blend of corporate bond index rates for 2 years through 2005. In July of 2003, the Department of the Treasury unveiled *The Administration Proposal to Improve the Accuracy and Transparency of Pension Information*. The proposal's stated purpose is to improve the accuracy of the pension liability discount rate, increase the transparency of pension plan information, and strengthen safeguards against pension underfunding.

[25]See 26 U.S.C. 412(b).

[26]For the analysis, PBGC used termination liabilities reported to it under 29 C.F.R. sec 4010.

insurance companies performed by the American Council of Life Insurers.[27]

Other aspects of minimum funding rules may limit their ability to affect the funding of certain plans as their sponsors approach bankruptcy. According to its annual reports, for example, Bethlehem Steel contributed about $3.0 billion to its pension plan for plan years 1986 through 1996. According to the reports, the plan had a credit balance of over $800 million at the end of plan year 1996. Starting in 1997, Bethlehem Steel reduced its contributions to the plan and, according to annual reports, contributed only about $71.3 million for plan years 1997 through 2001. The plan's 2001 actuarial report indicates that Bethlehem Steel's minimum required contribution for the plan year ending December 31, 2001, would have been $270 million in the absence of a credit balance; however, the opening credit balance in the plan's funding standard account as of January 1, 2001, was $711 million. Therefore, Bethlehem Steel was not required to make any contributions during the year.

Other IRC funding rules may have prevented some sponsors from making contributions to plans that in 2002 were terminated at a loss to the single-employer program. For example, on January 1, 2000, the Polaroid pension plan's assets were about $1.3 billion compared to accrued liabilities of about $1.1 billion—the plan was more than 100 percent funded. The plan's actuarial report for that year indicates that the plan sponsor was precluded by IRC funding rules from making a tax-deductible contribution to the plan.[28] In July 2002, PBGC terminated the Polaroid pension plan, and the single-employer program assumed responsibility for $321.8 million in unfunded PBGC-guaranteed liabilities for the plan. The plan was about 67 percent funded, with assets of about $657 million to pay estimated PBGC-guaranteed liabilities of about $979 million.

[27]Sponsors are required to provide PBGC with termination liability information if, among other things, the aggregate unfunded vested benefits at the time of the preceding plan year of plans maintained by the contributing sponsor and the members of its controlled group exceed $50 million, disregarding plans with no unfunded benefits. See 29 U.S.C. 1310(b). Among the information to be provided to PBGC is the value of benefit liabilities determined using the assumptions applicable to the valuation of benefits to be paid as annuities in trusteed plans terminating at the end of the plan year. See 29 C.F.R. 4010.8(d)(2).

[28]See 26 U.S.C. 404(a)(1) and 26 U.S.C. 412(c)(7). The sponsor might have been able to make a contribution to the plan had it selected a lower interest rate for valuing current liabilities. Polaroid used the highest interest rate permitted by law for its calculations.

Strengthening Plan Funding Rules Can Help Sponsors Maintain Well-Funded Plans

Several types of reforms might be considered to improve the funding of defined-benefit pension plans. Some options for reform would directly address funding requirements and related rules. Funding rules could be revised to require increased minimum contributions to underfunded plans and to allow additional contributions to fully funded plans. This approach would improve plan funding over time and improve the security of workers' benefits, while limiting the losses PBGC would incur when a plan is terminated. Such a change would require some sponsors to allocate additional resources to their pension plans, which may cause the plan sponsor of an underfunded plan to provide less generous wages or benefits than would otherwise be provided. Also, such funding rule changes could take years to have a meaningful effect on PBGC's financial condition. As examples of such funding rule revisions, the IRC could be amended to:

- **Base Additional Funding Requirement and Maximum Tax-Deductible Contributions on Plan Termination Liabilities, Rather than Current Liabilities.** Since plan termination liabilities typically exceed current liabilities, such a change regarding deficit reduction contributions would likely improve plan funding and, therefore, reduce potential claims against PBGC. One potential problem with this approach is the difficulty plan sponsors would have in determining the appropriate interest rate to use in valuing termination liabilities. As we reported, selecting an appropriate interest rate for termination liability calculations is difficult because little information exists on which to base the selection.[29]

- **Change Requirements For Making Additional Funding Contributions.** IRC requires sponsors to make additional contributions under two circumstances: (1) if the value of plan assets is less than 80 percent of its current liability or (2) if the value of plan assets is less than 90 percent of its current liability, depending on plan funding levels for the previous 3 years. Raising the threshold would require more sponsors of underfunded plans to make the additional contributions.

- **Limit the Use of Credit Balances by Severely Underfunded Plans to Avoid Additional Contributions.** For sponsors who make contributions in any given year that exceed the minimum required contribution, the excess plus interest is credited against future required contributions. Limiting the use of credit balances to offset contribution requirements

[29]GAO-03-313.

might also prevent sponsors of significantly underfunded plans from avoiding cash contributions. For example, in the absence of a credit balance, Bethlehem Steel would have been due to pay at least $270 million to its pension plan for the plan year ending December 31, 2001; however, because it showed a credit balance of $711 million as of January 1, 2001, Bethlehem was not required to make any cash contributions for that year. Limitations might also be applied based on the plan sponsor's financial condition. For example, sponsors with poor cash flow or low credit ratings could be restricted from using their credit balances to reduce their contributions.

- **Limit Lump-Sum Distributions by Plans That Are Significantly Underfunded**. Defined-benefit pension plans may offer participants the option of receiving their benefit in a lump-sum payment. Allowing participants to take lump-sum distributions from severely underfunded plans, especially those sponsored by financially weak companies, allows the first participants who request a distribution to drain plan assets, which might result in the remaining participants receiving reduced payments from PBGC if the plan terminates.[30] A "tiered system" may be set up whereby a plan that does not meet a certain funding ratio threshold might be prohibited from allowing highly compensated employees from taking benefits as lump sums; below a lower funding ratio threshold, lump-sum withdrawals for all employees might be prohibited. However, the payment of lump sums by underfunded plans may not directly increase losses to the single employer program because lump sums reduce plan liabilities as well as plan assets.

- **Raise the Level of Tax-Deductible Contributions**. IRC and ERISA restrict tax-deductible contributions to prevent plan sponsors from contributing more to their plan than is necessary to cover accrued future benefits.[31] This can prevent employers from making plan contributions during periods of strong profitability. Raising these limitations might result

[30]The administration's proposal would require companies with below investment grade credit ratings whose plans are less than 50 percent funded on a termination basis to immediately fully fund or secure any new benefit improvements, benefit accruals, or lump sums.

[31]Employers are generally subject to an excise tax for failure to make required contributions or for making contributions in excess of the greater of the maximum deductible amount or the ERISA full-funding limit.

in pension plans being better funded, decreasing the likelihood that they will be underfunded should they terminate.[32]

- **Expand Restrictions on Unfunded Benefit Increases**. Currently, plan sponsors must meet certain conditions before increasing the benefits of plans that are less than 60 percent funded.[33] Increasing this threshold, or restricting benefit increases or accruals when plans reach the threshold, could decrease the losses incurred by PBGC from underfunded plans. One disadvantage is that it could result in lower pension benefits for affected workers. In addition, plan sponsors have said that the disadvantage of such changes is that they would limit an employer's flexibility with regard to setting compensation, making it more difficult to respond to labor market developments. For example, a plan sponsor might prefer to offer participants increased pension payments or shutdown benefits instead of offering increased wages because pension benefits can be deferred—providing time for the plan sponsor to improve its financial condition—while wage increases have an immediate effect on the plan sponsor's financial condition.

- **Improve Funding of Shutdown Benefits**. Shutdown benefits provide significant early retirement benefit subsidies or other benefits offered to participants affected by a plant closing or a permanent layoff. Such benefits are primarily found in the pension plans of large unionized companies in the auto, steel, and tire industries. In general, shutdown benefits cannot be adequately funded before a shutdown occurs. Rules could mandate accelerated funding of shutdown benefits after they go into effect. However, if a plant shutdown coincides with the bankruptcy of a company and the termination of the pension plan, it may be impossible for the bankrupt sponsor to fund these benefits.

In addition to funding rules, plan sponsors need an accurate funding "target" that provides enough funding to pay promised current and future benefits while not leading sponsors to "overfund" their pension plans,

[32]For example, one way to do this would be to allow deductions within a corridor of up to 130 percent of current liabilities. Gebhardtsbauer, Ron. American Academy of Actuaries testimony before the Subcommittee on Employer-Employee Relations, House Committee on Education and the Workforce, Hearing on *Strengthening Pension Security: Examining the Health and Future of Defined-benefit Pension Plans.* (Washington, D.C.: June 4, 2003), 9.

[33]IRC provides generally that a plan less than 60 percent funded on a current liability basis may not increase benefits without either immediately funding the increase or providing security. See 26 U.S.C. 401(a)(29).

siphoning resources from other productive firm specific activities. The interest rate sponsors use to determine plan liabilities can affect this target and, therefore, plan funding. In 1987, when the 30-year Treasury bond rate was adopted for use in certain pension calculations, the Congress intended that the interest rate used for current liability calculations would, within certain parameters, reflect the price an insurance company would charge to take responsibility for the plan's pension payments. However, selecting a replacement rate that will provide an accurate funding target may be difficult because little information exists on which to base the selection.[34] In taking action to replace the 30-year Treasury bond rate, it is important to consider the impact that any change may have on funding. If Congress mandates the use of a rate that is "too high," plans are more likely to appear better funded, but minimum and maximum employer contributions would decrease, possibly increasing the likelihood of plan underfunding. In addition, some plans would reach full-funding limitations and avoid having to pay variable-rate premiums, and PBGC would receive less revenue. Conversely, a rate that is "too low" would make plans appear worse funded, with more plans likely to increase contributions and possibly pay variable-rate premiums. Thus, it may well be prudent for Congress to make any provision replacing the 30-year Treasury bond rate temporary to facilitate more comprehensive funding reform to take shape.

Other Reforms Might Enhance Sponsor Incentives to Maintain Plan Funding

In addition to direct changes to the funding rules, other reforms may result in improved plan funding by improving incentives for sponsors to maintain proper funding in their plans. These measures may prevent plans from terminating with severely underfunded balances, thus better protecting workers, retirees, and PBGC. For example, improving the availability of information to plan participants and others about plan investments, termination funding status, and PBGC guarantees may give plan sponsors additional incentives to better fund their plans, making participants better able to plan for their retirement. The restructuring of PBGC's premium

[34]Other than a survey conducted for PBGC, no mechanism exists to collect information on actual group annuity purchase rates. Compared to other alternatives, the PBGC interest rate factors may have the most direct connection to the group annuity market, but PBGC factors are less transparent than market-determined alternatives. Long-term market rates may track changes in group annuity rates over time, but their proximity to group annuity rates is uncertain. For example, an interest rate based on a long-term market rate, such as corporate bond indexes, may need to be adjusted downward to better reflect the level of group annuity purchase rates. However, as we stated in our report earlier this year, establishing a process for regulatory adjustments to any rate selected may make it more suitable for pension plan liability calculations. See GAO-03-313.

rates could also provide an incentive for plan sponsors to better fund their plans. It is also possible that basing changes to premium rates on the degree of risk posed by different plans may encourage financially healthy companies to remain in or enter the defined-benefit system while discouraging riskier plan sponsors. Moreover, it may be appropriate to consider modifying certain benefit guarantees that could decrease losses incurred by PBGC from underfunded plans. ERISA could be amended to:

- **Require Greater Disclosure of Information on Plan Investments.** Some information on the allocation of plan investments among asset classes—such as equity or fixed income—may be available from Form 5500s prepared by plan sponsors, but that information is not readily accessible to participants and beneficiaries. Additionally, some plan investments may be made through common and collective trusts, master trusts, and registered investment companies, and asset allocation information for these investments might need to be obtained from Form 5500s prepared by those entities or from their prospectuses. As such, improving the availability of plan asset allocation information to participants may give plan sponsors an incentive to increase funding of underfunded plans or limit riskier investments. Moreover, only participants in plans below a certain funding threshold receive annual notices regarding the funding status of their plans, and the information plans must currently provide does not reflect how the plan's assets are invested. One way to enhance notices provided to participants could be to include information on how much of plan assets are invested in the sponsor's own securities.[35] This would be of concern because should the sponsor become bankrupt, the value of the securities could be expected to drop significantly, reducing plan funding. Although this information is currently provided in the plan's Form 5500, it is not readily accessible to participants. Additionally, if the defined-benefit plan has a floor-offset arrangement and its benefits are contingent on the investment performance of a defined-contribution plan, then information provided to participants could also disclose how much of that defined-contribution plan's assets are invested in the sponsor's own securities.
- **Require Greater Disclosure of Plan Termination Funding Status.** Under current law, sponsors are required to report a plan's current liability for funding purposes, which often can be lower than termination liability.

[35]Although ERISA permits plan sponsors to invest plan assets in employer stock, defined-benefit plans may not acquire any qualified employer security or real property if immediately after the acquisition the aggregate fair market value of such assets exceeds 10 percent of the fair market value of the plan's total assets.

In addition, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans.[36] As a result, many plan participants, including participants of the Bethlehem Steel pension plan, did not receive such notifications in the years immediately preceding the termination of their plans. Expanding the circumstances under which sponsors must notify participants of plan underfunding might give sponsors an additional incentive to increase plan funding and would enable more participants to better plan their retirement. Under the Administration's proposal, all sponsors would be required to disclose the value of pension plan assets on a termination basis in their annual reporting. The Administration proposes that all companies disclose the value of their defined-benefit pension plan assets and liabilities on both a current liability and termination liability basis in their Summary Annual Report (SAR).[37]

- **Increase or Restructure Variable-Rate Premium.** PBGC charges plan sponsors a variable-rate premium based on the plan's level of underfunding, premiums, with sponsors paying $9 per $1,000 of unfunded liability. However, the recent terminations of Bethlehem Steel, Anchor Glass, and Polaroid, plans that paid no variable-rate premiums shortly before terminating with large underfunded balances, suggest that the current structure of the variable-rate premium does not provide a strong enough incentive to improve plan funding or is too easily avoidable. The rate could be adjusted so that plans with less adequate funding pay a higher rate. In addition, premium rates could be restructured based on the degree of risk posed by different plans, which could be assessed by considering the financial strength and prospects of the plan's sponsor, the risk of the plan's investment portfolio, participant demographics, and the plan's benefit structure—including plans that have lump-sum,[38] shutdown

[36]The ERISA requirement that plan sponsors notify participants and beneficiaries of the plan's funding status and limits on the PBGC guarantee currently goes into effect when plans are required to pay variable-rate premiums and meet certain other requirements. See 29 U.S.C. 1311 and 29 C.F.R. 4011.3.

[37]Participants and individuals receiving benefits from their plan must receive a Summary Annual Report (SAR) from their plan's administrator each year. The SAR summarizes the plan's financial status based on information that the plan administrator provides to the Department of Labor on its annual Form 5500. This document must generally be provided no later than nine months after the close of the plan year.

[38]For example, a plan that allows a lump-sum option—as is often found in a cash-balance and other hybrid plan—may pose a different level of risk to PBGC than a plan that does not.

benefit, and floor-offset provisions.[39] One advantage of a rate increase or restructuring is that it might improve accountability by providing for a more direct relationship between the amount of premium paid and the risk of underfunding. A disadvantage is that it could further burden already struggling plan sponsors at a time when they can least afford it, or it could reduce plan assets, increasing the likelihood that underfunded plans will terminate. A program with premiums that are more risk-based could also be more challenging for PBGC to administer.

- **Phase-in the Guarantee of Shutdown Benefits**. PBGC is concerned about its exposure to the level of shutdown benefits, or benefit increases that are unfunded at termination.[40] PBGC could phase-in the guarantee of such benefits. Similar to benefit increases prior to termination, the agency could perhaps guarantee an additional 20 percent of shutdown benefits each year after the benefits are offered, with full benefits (up to PBGC limits) guaranteed only after 5 years. Phasing in guarantees from the date of the applicable shutdown could decrease the losses incurred by PBGC from underfunded plans.[41] A phase-in might cause workers to put pressure on sponsors to fund these benefits or benefit increases, or demand alternative forms of compensation. Modifying these benefits would reduce the early retirement benefits for participants who are in plans with such provisions and are affected by a plant closing or a permanent layoff. Dislocated workers, particularly in manufacturing, may suffer additional losses from lengthy periods of unemployment or from finding reemployment only at much lower wages.

[39]Under the floor-offset arrangement, the benefit computed under the final pay formula is "offset" by the benefit amount that the account of another plan, such as an Employee Stock Ownership Plan, could provide.

[40]PBGC guarantees benefits up to certain limits. PBGC may pay only a portion of the claim because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee annual benefits above a certain amount, currently about $44,000 per participant at age 65. Additionally, benefit increases in the 5 years immediately preceding plan termination are not fully guaranteed, though PBGC will pay a portion of these increases. The guarantee does not generally include supplemental benefits, such as the temporary benefits that some plans pay to participants from the time they retire until they are eligible for Social Security benefits.

[41]Currently, some measures exist to limit the losses incurred by PBGC from certain terminated plans. PBGC is responsible for only a portion of all benefit increases that the sponsor adds in the 5 years leading up to termination.

Conclusion

Widespread underfunding in the defined-benefit pension system potentially threatens the retirement security of millions of American workers. The termination of severely underfunded plans can significantly reduce the benefits promised to workers and retirees. It also threatens the solvency of PBGC's single-employer insurance program, with, in the worse case, Congress facing the choice of a bailout or of letting affected workers and retirees lose the pension benefits they depend on. While the pension system does not face an immediate crisis, these serious financial challenges suggest that meaningful, if perhaps difficult, comprehensive action needs to be taken. Such action would be aimed towards the improvement of the long-term funding status of plans and the accountability of plan sponsors, especially those that represent a clear risk to PBGC, plan participants, and their beneficiaries.

Undoubtedly, unfavorable economic conditions have contributed to widespread underfunding and conspired to place well-meaning sponsors in very difficult positions to maintain their plans' funding. Although comprehensive reform should include improving plan funding as the key vehicle to stabilize and enhance the long-term health of the defined-benefit system, Congress may seek to balance improvements in funding and accountability against the short-term needs of some sponsors who may have difficulty making contributions to their plans. Relief measures should be carefully targeted to those sponsors that may need it most urgently, with some provision for this aid to eventually lead to improved plan funding. In crafting this reform, the Congress should be wary of temporary rule changes directed exclusively to short-term problems that could increase the risk that plans terminate in even worse financial straits than they suffer today.

It is important to keep in mind that the factors contributing to the deterioration of pension plan funding go beyond the effects of the recent economic downturn. The defined-benefit system has shown signs of stagnation for the past 2 decades, with a steady decline in the number of plans and a decreasing proportion of working participants. PBGC's participant base may also be concentrated in more vulnerable industries. Concerns about PBGC's long-run financial viability, and not just the recent alarming jump in its accumulated deficit, prompted us to put the single-employer program on our high-risk list. While it is unlikely that any rules can guarantee that all plans are fully funded at all times, nor should that be their goal, regulations should strive to maintain the overall health of the system and prevent poor economic conditions from creating a general funding crisis.

In addition to the administration's current proposal, the Treasury Department, Labor Department, and PBGC are considering reforms that seek to address many of these issues and include elements of the options that I have identified in my testimony, such as increased transparency for plan participants. The private defined-benefit pension system is at a crossroads, facing a threat of continued financial erosion and decline. However, we also have the opportunity and the challenge to broadly move the system back to a solid, stable financial footing that will provide needed retirement benefits to workers and retirees for decades to come.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions that you or other members of the Committee may have.

For information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215 or Charles A. Jeszeck on (202) 512-7036. Individuals who made key contributions to this testimony are Mark M. Glickman, Jeremy Citro, Daniel F. Alspaugh, and John M. Schaefer.

Chairman BOEHNER. Thank you, Ms. Bovbjerg.
Mr. Krinsky?

STATEMENT OF ROBERT D. KRINSKY, A.S.A., E.A., CHAIRMAN, THE SEGAL COMPANY, NEW YORK, NY, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL

Mr. KRINSKY. Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today. I am Robert Krinsky, chairman of The Segal Company, a benefits compensation and human resources consulting firm that I have been with for over 49 years, more than 20 years before ERISA passed.

I am appearing on behalf of the American Benefits Council, of which I am a member of the executive committee of the board, and a former chairman.

As you are undoubtedly aware, the pension funding rules are extraordinarily complex. We commend the Committee for holding this hearing to study them more fully. Because of the complex nature of the funding rules, it is critical that the ramifications of any proposed changes be understood. Otherwise, hasty policy action is likely to produce counter-productive results that would further harm our already troubled defined benefit system.

When examining the rules, we must remember that old admonition, "First, do no harm." Before addressing the funding rules generally, I wanted to call attention to the most bothersome—even, I will say nonsensical—of them all, and one which I know the Members of the Committee are aware, the required use of the 30-year Treasury rate for various pension calculations.

The Council strongly endorses adopting a corporate bond rate replacement for this obsolete rate. We thank the Members of this Committee, and particularly you, Mr. Chairman, Ranking Member Miller, and Mr. Andrews, for working to develop and pass H.R. 3108, which provides a 2-year corporate bond rate replacement.

When ERISA was first enacted in 1974, the goal was to strike the proper balance between encouraging employees to maintain defined benefit plans and ensuring the security of participants' benefits. The initial ERISA regime was largely successful because it recognized the long-term nature of pension promises and sought to reduce the volatility of contributions.

ERISA also succeeded because it was the result of a deliberative, inclusive process that sought to address the concerns of pension system stakeholders. This positive start was disrupted in the 1980's, however, as Congress built layer upon layer of overlapping and sometimes contradictory rules. Congress lowered the maximum deductible contribution that employers could make to pension plans, imposed an excise tax on contributions that were not deductible, and placed confiscatory penalties on withdrawals of surplus assets after plan termination.

These changes severely limit the ability to fund plans during good economic times while requiring sizable contributions during difficult times, a result that makes no sense and that encourages employers to keep their plans as near as possible to the minimum funding level.

This is not to say that a wholesale reworking of the defined benefit funding rules is in order. It is not. The use of the obsolete 30-year Treasury rate, coupled with recent market interest rate and economic conditions—a veritable perfect storm, as the Chairman indicated—of adverse pension funding circumstances, should be expected to produce temporary funding deficiencies that will correct as conditions improve, and once Congress replaces the 30-year rate. We have, in fact, seen the beginning of such corrections recently.

The real challenge is to look beyond today's unique circumstances to identify areas where reform is both desirable and achievable, and to act only after careful deliberation. Already, at a specific request from the administration, the Council has begun developing suggestions for constructive reforms, and we also look forward to working with Congress and Members of this Committee.

We have identified a number of areas, discussed in much greater detail in our written testimony, where changes might be warranted.

First, the funding rule should seek to reduce volatility and allow for more regular and predictable contributions. Conversely, any changes that would increase funding volatility, such as the spot rate yield curve approach that has been advanced by the Treasury Department, should be rejected.

Second, restrictions on the deductibility of pension contributions should be eased.

Third, the deficit contribution regime should be reformed so that it still achieves the goal of ensuring that plans are well funded, but does so in a less punitive manner.

Fourth, the current rules regarding assets and overfunded plans, which are a deterrent to funding in good times, should be reviewed.

Last, the rules should be streamlined where possible, such as streamlining the multiple definitions of plan viability.

While it is possible to identify these general areas in which improvements may be feasible, the devil is always in the details. Our particular concern is that any changes be accompanied by appropriate transition rules, without which even constructive reforms could be detrimental.

I want to close by saying a few words about the financial status of the PBGC, which has attracted significant attention recently. Council members that voluntarily maintain retirement plans and pay the premiums to support the PBGC strongly believe that the agency should be operated on a sound financial basis.

Having said that, we believe that the long-term position of the PBGC is strong, and do not see cause for alarm. While the PBGC is currently reporting a deficit, it has done so for most of its history.

Moreover, the relatively modest size of its reported 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.

Thank you. I would be pleased to answer your questions.

[The prepared statement of Mr. Krinsky follows:]

Statement of Robert D. Krinsky, A.S.A., E.A., Chairman, The Segal Company, New York, NY, on Behalf of the American Benefits Council

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today. I am Robert D. Krinsky, A.S.A., E.A., Chairman of The Segal Company. I am appearing on behalf of the American Benefits Council (the Council). I am a former chair of the Council and currently serve on the Executive Committee and 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.

The Segal Company is a benefits, compensation and human resources consulting firm with about 1,000 employees and 17 offices in the United States and Canada. Our Company is owned by its employees. Since the late 1950s, we have sponsored a final-average-pay pension plan for our employees, plus an employer-funded profit sharing plan that now includes a 401(k) feature. Our Company has been successful in retaining long-service employees, despite all the discussion about increased employee mobility. For example, I have been working for Segal in one capacity or another for some 49 years, rising from statistical clerk (during summer vacation) to head of the actuarial department (I am an Associate of the Society of Actuaries and an Enrolled Actuary) to CEO and then Chairman of the Board. While tenures of that length are rare even within our company, we are proud of the longevity of our employees' careers with us. Even after 40% growth in our employee population in the past 2 to 3 years, 235 of our employees have been with us for more than 10 years, 85 of them for more than 20 years. I cannot say that it is our defined benefit plan, standing alone, that has instilled such loyalty, but it is certainly an important element in the long-term commitment that we make to our employees in return for their commitment to our enterprise.

Recently, there has been considerable attention focused on defined benefit pension funding and the unprecedented set of financial circumstances currently facing these pension plans. Today, we are here to examine the current rules—found in the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code—that govern defined benefit pension funding. As you undoubtedly are aware, the pension funding rules are extraordinarily complex. The Council commends the Committee for convening this hearing to study and come to a better understanding of the operative rules. Absent such careful study and deliberation, hasty action is likely to produce counter-productive results for the millions of American workers and retirees who depend on defined benefit pensions for retirement income.

Indeed, let me emphasize at the outset that largely because of the complex nature of today's pension funding rules, it is critically important that the full ramifications of any proposed changes to these rules be fully understood. Given the density of the interlocking statutory constraints, cross-references and directives, serious unintended consequences are almost guaranteed unless the impact of each change is clearly and fully identified. Otherwise, severe harm could be done to our defined benefit system, which is already in grave danger of spiraling toward extinction. As we examine the rules governing defined benefit funding, we must remember that old admonition—"First, do no harm."

Before I turn to addressing the defined benefit funding rules generally, I want to call attention to an issue about which I know the members of this Committee are all aware—the urgent need to replace the 30-year Treasury bond interest rate for various pension funding calculations. I will discuss the 30-year Treasury rate in more detail later, but suffice it to say that the required use of this obsolete rate is the most nonsensical of all the current funding rules—and one that requires immediate action. The Council strongly endorses replacing the obsolete 30-year Treasury rate with a corporate bond rate based on a blend of one or more conservative long-term corporate bond indices. We commend the efforts of the members of this Committee, and particularly you, Mr. Chairman, and Ranking Member Miller, in working to develop and pass H.R. 3108, which provides for a two-year corporate bond rate replacement.

Background on Defined Benefit Plans

Defined benefit plans play a vital role in our voluntary, employment-based retirement system, and offer a number of unique features that enhance the retirement security of American workers and retirees. Employers generally bear responsibility for designing these plans to match their human resources objectives, funding them, investing plan assets, and ensuring that assets are sufficient to pay promised benefits. Defined benefit plans also offer annuity benefits for both retirees and their spouses, which are guaranteed by the federal government through the Pension Benefit Guaranty Corporation (PBGC). In addition to these many advantages for employees, employers also value defined benefit plans as a means of rewarding and managing their workforce. And, these plans benefit the economy as a whole by providing a ready source of professionally-managed, long-term investment capital.[1]

As of 1998 (the most recent year for which official Department of Labor statistics exist), approximately 42 million Americans were participants in defined benefit pension plans, and these plans paid more than $111 billion in benefits to more than 18 million retirees in that year alone.[2] Yet while the defined benefit system helps millions of Americans achieve retirement income security, it is a system in severe decline. Employer sponsors confront a variety of threats that have led many of them to terminate their defined benefit plans. The total number of government-insured defined benefit plans has decreased from 114,500 in 1985 to fewer than 33,000 such plans in 2002.[3] Looking at this decline over just the past several years makes this downward trend all the more stark. From 1999 through 2002, there has been a decrease of over 7,500 PBGC-insured defined benefit plans—from 39,882 to 32,321 plans—or 19 percent in just three years.

And these statistics 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 new pension benefits for existing employees and no pension benefits whatsoever for new hires. If frozen plans were officially tracked by the government (and they clearly have been on the increase in recent months), the decline of our nation's defined benefit pension system would be even more apparent. Information from Council members that serve as benefits consultants to employers is that between 15 percent and 20 percent of defined benefit plan sponsors have either already frozen their plans in recent months or are seriously considering doing so. Moreover, there are virtually no examples of frozen plans "thawing out" so that benefits begin to accrue once again. In the face of this decline in the defined benefit system, it is critically important to be certain that any policy changes under consideration ameliorate, rather than exacerbate, the problems in the current regime.

Even if the decline in employment-based defined benefit plans levels off, the consequences could be ominous for our public retirement income programs. It is unlikely that the baby boomers will be content with a sharp drop in their standard of living in retirement. Without reasonable pensions to rely on, they will be all the more dependent on Social Security, and on Congress's willingness to continue providing generous Social Security benefits.

Today's Defined Benefit Funding Regime

When the first comprehensive pension funding regime was enacted in 1974 in ERISA, the goal was to strike the proper balance between encouraging employers to maintain defined benefit plans for their employees and ensuring the security of benefits earned under these plans.[4] And following ERISA's enactment, the rules generally worked well. Funding levels of company pension plans improved, and defined benefit plan sponsorship and coverage increased.[5] The initial ERISA regime was successful in large part because it recognized the long-term nature of pension plans and their underlying liabilities, and sought to reduce the volatility of pension contribution requirements by allowing plans to use so-called "smoothing" techniques that average interest rate and asset value fluctuations over a number of years. Another primary reason for ERISA's initial success is that it was the result of a delib-

[1] Private-sector defined benefit plans held $1.6 trillion in assets as of 2002. See Joint Committee on Taxation, Present Law and Background Relating to the Funding Rules for Employer–Sponsored Defined Benefits Plans and the Financial Position of the Pension Benefit Guaranty Corporation, JCX—39–03, April 29, 2003, page 49. These defined benefit plan holdings represent approximately 6 percent of all U.S. stock equity holdings. See Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System, June 5, 2003, page 103; U.S. Census Bureau, Statistical Abstract of the United States, 2002 , page 732, Table 1173.

[2] Private Pension Plan Bulletin, Abstract of 1998 Form 5500 Annual Reports, U.S. Dept. of Labor, Number 11, Winter 2001–2002, Table E1; U.S. Census Bureau, Statistical Abstract of the United States: 2002, No. 524.

[3] 2002 PBGC Annual Report, page 13.

[4] The ERISA rules were crafted in part in response to events at certain companies—the Studebaker automobile company being the most oft-cited example—where the company had not adequately funded its pension plan and was unable to meet the pension obligations it owed its employees and retirees.

[5] From 1978 to 1983, the percentage of plans with accrued benefit security ratios of 1.0 or greater increased every year, rising from 25 percent in 1978 to 64 percent in 1983. Watson Wyatt Worldwide, 1983 Survey of Actuarial Assumptions and Funding, p. 15, 1986 Survey of Actuarial Assumptions and Funding, p., 4., (Bethesda, MD: Watson Wyatt Worldwide). During that same time period, the number of defined benefit pension plans and participants in those plans also increased—from 128,407 plans in 1978 to 175,143 plans in 1983 and from 29,036,000 participants in 1978 to 29,964,000 participants in 1983. U.S. Department of Labor, Pension and Welfare Benefits Administration, Private Pension Plan Bulletin (Spring 1999), no. 8, pp. 64, 67, 77, and 80.

erative, multi-year process that was inclusive and sought to address concerns raised by the various pension system stakeholders.

Beginning in the 1980's however, Congress began to interfere with the operation of the funding rules, building layer upon layer of often overlapping and sometimes contradictory rules (all too often enacted in response to hypothetical or isolated abuses or as a means of raising federal revenue). By way of example, beginning in 1986, Congress enacted short-sighted, revenue-driven restrictions that lowered the maximum tax-deductible contribution that employers could make to pension plans, imposed a significant excise tax on employer contributions that were not tax-deductible, and placed potentially confiscatory penalties on withdrawals of surplus assets after plan termination.

Each of these actions served to discourage employers from contributing to their pension plans. These rules severely limit the ability of companies to fund their plans during good economic times, while requiring sizeable additional contributions during difficult economic times—a result that makes no sense from either a business planning or a policy perspective. Thus, 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.[6] Although some limited relief from these deduction restrictions has been provided since 1997, the overall result of the current pension funding rules is to 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. As we examine today's funding rules, we should pay heed to the mistakes that have been made in the past, make reforms and improvements where needed, and be sure not to repeat the policy errors that have placed our defined benefit system in jeopardy.

This is not to say that a wholesale reworking of the defined benefit funding rules is in order. It is not. Nor should anyone make the mistake of assuming that the underfunding caused by the recent business cycle and an anomalous asset and interest rate environment indicate a need for a hasty overhaul of the funding rules. They do not. The nonsensical use of the obsolete 30-year Treasury rate, coupled with recent market, interest rate, and economic conditions—a veritable “perfect storm” of adverse pension funding circumstances—should be expected to produce temporary funding deficiencies that will correct as conditions improve and once Congress replaces the 30-year rate. We have, in fact, seen the beginning of such corrections over the past few months. Indeed, it would be a surprise if there were not a reduction in the funded status of pension plans during periods of general economic downturn. Thus, the real challenge with respect to the current funding rules is to look beneath today's unique circumstances to identify those areas where reform is both desirable and achievable and to act accordingly only after careful study and deliberation.

It should also be noted that reexamination of the defined benefit funding rules and the specter of changes to these rules is itself destabilizing to the defined benefit system. Companies need to make long-term judgments concerning the costs associated with their defined benefit plans and how such plans integrate with their financial and business strategies. Thus, the long and continued history of gyrations in the defined benefit funding rules is itself a negative feature.

With that in mind, let me discuss a number of areas where we believe improvements to the current rules may be possible. Already, as a result of a specific request from the Bush Administration, the Council has begun engaging with Treasury Department and other Administration officials on constructive reforms that we believe are achievable. We look forward to working with Congress and Members of this Committee on these issues as well. In particular, we have identified the following areas where further study of possible changes is warranted:

- Funding Volatility—Funding Opportunities and Requirements. Both funding opportunities and funding requirements in the defined benefit system are too erratic and do not offer enough flexibility to plan sponsors to make contributions. The funding rules should seek to reduce volatility, and allow for more regular and predictable contributions regardless of the funded status of the plan. In this regard, smoothing mechanisms that recognize the long-term nature of pension commitments by allowing plans to average interest rate and asset value fluctuations over a number of years must be preserved, and should be expanded where appropriate. Concomitantly, any changes to the system that would increase funding volatility should be rejected, as volatility in required contributions is already one of the primary factors driving employers from the defined benefit system.

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

- Deductibility of Contributions. The current funding regime disallows employer tax deductions for defined benefit plan contributions when plans are reasonably well-funded, and, indeed, imposes an excise tax on such contributions. Legislative enactments in recent years have made improvements so that more employers can continue funding their plans as their funded status improves, but further improvements in this area are warranted. The business reality is that if employers are discouraged from making additional contributions when they may be in the very best financial position to do so, they cannot build the cushion of funding needed for future periods of economic stress.
- Deficit Reduction Contributions. While the two-tiered funding regime embodied in current law—which requires sponsors of all plans to make sufficient contributions to meet estimated future liabilities and requires additional, so-called "deficit reduction" contributions to certain underfunded plans—is effective to some extent in customizing funding requirements to plans' actual funded status, the current deficit reduction contribution regime is often unduly punitive. If deficit reduction contributions are imposed on a plan, very substantial amounts of cash must be contributed very quickly, often at a time when companies are less well-positioned to make such substantial contributions. The policy logic behind this structure is particularly questionable when one considers the long-term nature of pension promises. The sudden and onerous nature of the deficit reduction contribution regime leads some pension plan sponsors to freeze their defined benefit plans, which is typically preparatory to an outright termination. Consideration should be given to restructuring the deficit contribution regime so that it still achieves the underlying goal of ensuring that plans are well-funded, but does so in a less punitive manner.
- Lump Sum Payments. The payment of lump sum distributions to defined benefit plan participants exacerbates funding problems for many plans. In part because lump sum calculations are currently based on the obsolete 30-year Treasury rate, lump sum payments are artificially inflated, and inappropriately drain plan assets. It is important to address the growing prevalence and use of the lump sum distribution option and determine whether this necessitates changes in the funding rules.
- Definition of "Liability". The multiple definitions of liability in the funding rules are unduly complex, and should be streamlined.
- Treatment of Assets in Overfunded Plans. The current rules regarding the treatment of assets in overfunded plans act as a deterrent to building funding cushions in good times, and should be reviewed.

Some in Congress have already advanced proposals for targeted reforms to the pension funding rules, and I will mention three that the Council strongly endorses.[7]

- Deductibility of Defined Benefit Plan Contributions. The limit on deductions for contributions to a defined benefit plan would be increased so that the maximum amount otherwise deductible is not less than 130 percent of the plan's unfunded current liability (instead of 100 percent of unfunded current liability as under present law).
- Plan Asset Valuations. Instead of the overly rigid current law rules regarding the timing of plan asset valuations, employers would—for funding and deduction purposes—be allowed to value liabilities as of the first day of the plan year, while valuing assets as of the last day of the plan year. This would allow employers to fund their plans with increased contributions to compensate for asset declines during the course of the year.
- Deduction Rule Relief for Employers That Sponsor Both Defined Benefit and Defined Contribution Plans. Another proposal would revise the current law rules that restrict the deductibility of contributions by employers that sponsor both defined benefit and defined contribution plans to the greater of defined benefit minimum funding requirements or 25 percent of pay. Specifically, this proposal would allow contributions to a defined contribution plan equal to up to 6% of participants' pay to be disregarded in applying this rule.

While it is possible—as we have done above—to identify general areas in which improvements to the pension funding rules may be feasible, the viability of any proposed changes will turn largely on the details of such proposals. One area of particular concern to the Council is that any changes be accompanied by appropriate and adequate transition rules. If such transition rules are not provided, even otherwise constructive reforms could have a detrimental effect on defined benefit plans

[7] The first of these proposals is included in the National Employee Savings and Trust Equity Guarantee Act, as reported by the Senate Finance Committee on September 17. The other two proposals are included in H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, as introduced by Representatives Rob Portman (R–OH) and Ben Cardin (D–MD).

and the employees and families who depend on these plans. As such, the ultimate position of the Council or any of its member companies with respect to pension funding reform proposals will depend on a careful review of the details and specifics of any such proposal, including fair transition into any new regime.

Other Defined Benefit Plan Issues

Replacement of the Obsolete 30–Year Treasury Rate—As I mentioned at the beginning of my remarks, the need to replace the obsolete 30-year Treasury rate for pension calculations is the most pressing issue facing the defined benefit pension system today. Without prompt action to correct this problem, the exodus of employers from the defined benefit system will only accelerate.

Under current law, employers that sponsor defined benefit pensions are required to use the 30-year Treasury 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 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 thought to be an acceptable proxy for other long-term investments. While a variety of rates were discussed when the 30-year Treasury rate was first selected in 1987, it was believed at the time that it reflected the appropriate benchmark whereby companies could reasonably set aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

In 1998, the U.S. Treasury Department began retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year 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 interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other debt instruments. In testimony before Congress, Bush Administration officials have stated that, "[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities." [8]

The result of using the obsolete 30-year Treasury is that pension liabilities are artificially inflated, and employers are required to make excessive pension contributions and PBGC variable premium payments. Perhaps more than any other factor, these inflated and uncertain financial obligations imposed on employers have contributed to the spate of plan freezes and terminations in recent years. Today's inflated funding requirements also harm the economy and have a direct adverse impact on workers since cash inappropriately mandated 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 reasonably 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. Indeed, some employers may be forced to lay off employees in order to finance the required cash contributions to their pension plans.

Last year in the March 2002 economic stimulus act, Congress enacted a temporary interest rate adjustment that expires at the end of this year. Since 2002, the 30-year Treasury rate has only become progressively more obsolete, and the associated problems described above have become more grave. For this reason, action on a 30-year Treasury rate replacement is imperative.

We strongly believe that the appropriate replacement for the defunct 30-year Treasury rate is a rate based on a composite blend of the yields on high-quality corporate bonds. A corporate bond blend steers a conservative course that fairly and appropriately measures pension liabilities. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. A benchmark based on such rates would also provide the predictability necessary for a company to plan its pension costs in the context of its overall business.

Use of such a conservative corporate bond blend would also ensure that plans are funded responsibly. 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 many stakeholders from

[8] 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).

across the ideological spectrum—from business to organized labor—agree that the 30-year Treasury rate should be replaced on a permanent basis by a conservative, high-quality corporate bond blend.

We commend the House for passing H.R. 3108, which provides for the use of a corporate bond rate for the next two years, in an overwhelming bipartisan vote earlier this month. In particular, Mr. Chairman, we commend your leadership and the efforts of Ranking Member Miller and other members of this Committee in passing H.R. 3108. We urge you to continue these efforts by working with the Senate to promptly enact this critically important legislation.

Yield Curve. Separately, 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 such a yield curve concept would mark a major change in our defined benefit system to a volatile and complicated regime under which the interest rates used would be based on immediate spot rates and vary with the schedule and duration of payments due to plan participants.

We believe the yield curve—and the associated proposals to eliminate interest rate averaging—would exacerbate funding volatility and increase complexity, all for, at best, only a marginal increase in accuracy. Such a spot rate approach ignores the long-term nature of pension plans, and represents an approach to valuing pension liabilities rooted in theoretical economics. This academic mechanism disregards the real world business environment that companies actually face—one in which extremely volatile pension contribution patterns cause employers to abandon defined benefit plans altogether.

There also are a host of unanswered questions created by the yield curve. For example, how would such a concept apply to the calculation of lump sums? to the payment of interest credits under cash balance plans? or to the calculation of PBGC variable premium obligations? The effect of adopting such a spot-rate yield curve has not been properly analyzed, and there is simply no way that all of the outstanding issues could be addressed in the short time available to replace the 30-year Treasury rate. Even if there were time to study these issues, we believe—based on the information available to date—that the yield curve is a flawed approach that could do serious harm to our defined benefit system.

Moreover, even if these technical and financial problems with the yield curve were resolved, there is another dimension that, we submit, merits consideration. We have all heard that young, mobile employees attribute little value to defined benefit plans, preferring 401(k) accounts that they control. From my experience as an advisor to plan sponsors and as the head of a company that sponsors a defined benefit plan, I can assure you that that is largely true. But, "young, mobile workers" are only part of our labor force. There is no question that defined benefit plans are of real interest and appeal to older employees. Emerging demographics demonstrate that employers will increasingly need to attract and retain older employees, and I am convinced that defined benefit plan offerings will be powerful instruments for doing so. The aging of the American workforce could provide an impetus for a revival of defined benefit plans.

But, any such movement to revive defined benefit plans as employers' and employees' need for them revives would be blunted by use of a yield curve approach to plan funding. Quite simply, it would make it extra expensive for employers to provide or enrich decent retirement income for older workers. In years past, pension plans were initiated at the instigation of older employees, or as a result of management's wish to offer them a graceful, dignified route out of the workforce. Those motivations will return, with the modern goal being to attract or retain experienced workers with the promise of reliable retirement income after their extended careers. Yet the yield curve funding approach, elegant as it may appear to financial economists, would make defined benefit pension plans unaffordable for the very companies and employees that most need them.

Administration Proposals Regarding Disclosure and Mandatory Pension Freezes. I also want to touch briefly on proposals that the Administration has advanced that are also related to pension funding—namely additional disclosure of pension information and mandated freezes of certain pension plans. 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 a plan's termination liability could provide a misleading depiction of plan finances for well-funded, ongoing plans that are not in any danger of terminating. This type of misleading disclosure could unnecessarily and falsely alarm plan participants, financial markets, and shareholders. Not only would the information be of questionable merit, the need to determine it would impose yet another costly administrative burden on pension plan sponsors.

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 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. The disclosure of confidential business information would also be problematic for public companies. For closely-held companies like ours, the risk that gyrations in the stock market could force disclosure and publication of the details of our finances would be a powerful reason not to sponsor a defined benefit plan at all.

The Administration has also come forward with a proposal that would freeze accruals, remove lump sum rights, and prohibit benefit improvements in defined benefit plans when a company reaches a certain level of underfunding and receives a junk bond credit rating. We share the Administration's concerns about PBGC guarantees of benefit improvements that are made by financially troubled companies, and believe this is an area for further study and possible action. From a policy perspective, it does not make sense to allow financially troubled companies with underfunded plans to continue offering benefit improvements; and it is the well-funded, PBGC premium-paying plan sponsors that will be on the hook for these liabilities. We also believe that it is appropriate to examine whether the health of these plans (and ultimately the PBGC) is harmed by allowing participants in these plans to drain plan assets by taking lump sums. At the same time, however, the Administration's proposal raises technical and policy issues that require further examination. We would, for example, draw a distinction between prohibiting benefit improvements and freezing the plan altogether, i.e., not allowing participants to continue benefit accruals under the current plan formula. In addition, from a technical perspective, the Administration has not provided a definition of "junk bond" status, resulting in confusion about the scope of the proposal. In short, we agree with many of the goals of the Administration's proposal for underfunded plans, but believe it merits further analysis and likely some modifications.

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. Nonetheless, while the PBGC's deficit should be monitored, we believe that the long-term financial position of the PBGC is strong and we do not believe the PBGC's current deficit indicates a threat to its viability. In short, it would be inappropriate to be alarmed and overreact.

Today, the PBGC has total assets in excess of $25 billion, and it earns money from investments on those assets. While the PBGC reports liabilities of 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 should also be noted that these liability projections by the PBGC are based on unrealistic interest rate and mortality assumptions, which make the agency's liabilities appear larger than they actually are.

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 also 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.

Let me close my remarks on the PBGC by underscoring that 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. Because we have always predominantly represented companies with very well-funded plans, 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. At the same time, however, we all must recognize that pension policy should not be driven by seeking to entirely eliminate all financial risk to the PBGC. As an entity that is essentially in the insurance and risk management business, a limited number of plan failures is to be expected and, indeed, that is what pension premium income is for. Complete elimination of PBGC risk could only be achieved by an extraordinarily rigid and expensive pension funding system—one in which no employer would be willing to participate. The key is to monitor the PBGC's position with a long-term view and to foster policies that promote a healthy and vibrant defined benefit system in which employers representing the full range of American business participate.

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, yet today these plans are under assault on a variety of fronts. Hybrid plans were developed to offer a way to correct a mismatch between the traditional pension design and the needs of mobile workers. The traditional pension design focuses its benefits on employees with long service relative to employees with less than career-long employment at their firm. In industries in transition and with mobile workforces, numerous studies show that the more even benefit accrual formula of hybrid pension plans can deliver higher benefit levels to a greater number 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.

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. At the regulatory agencies, there are several pending 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—particularly the Transportation–Treasury appropriations bill—to deny funding for such projects. The Council strongly opposes these efforts to affect complex pension policy through the appropriations process, and urges Congress to reject them. 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 (H.R. 1677 and H.R. 2101 in the House and S. 825 in the Senate) that would mandate that employers converting a traditional defined benefit plan to a hybrid pension plan allow employees to elect whether they wish to receive their hybrid pension plan benefit or a benefit under the traditional defined benefit plan. 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. If this plan design flexibility were hobbled, in effect freezing all corporate policy decisions regarding pensions in concrete, responsible managers—who would be unable to make these unalterable benefit commitments—would be pushed to depart the defined benefit system as quickly as possible.

Conclusion

Thank you for the opportunity to present our views. Defined benefit plans offer many unique advantages for employees, and the employers that sponsor these pension plans sincerely believe in their value. Today, however, these plans are in danger—largely as a result of short-sighted and counter-productive changes to the pension funding rules over the past two decades. These flaws must be corrected, but only in the context of a considered and careful review. The consequences of error and misstep in this endeavor for the retirement security of American families are simply too great. We look forward to working with Members of this Committee, Congress, and the Administration to address the challenges facing defined benefit plans and to ensure a healthy and vibrant defined benefit system.

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

Chairman BOEHNER. Thank you, Mr. Krinsky.

And Mr. Gordon?

STATEMENT OF MICHAEL S. GORDON, GENERAL COUNSEL, NATIONAL RETIREE LEGISLATIVE NETWORK, INC., WASHINGTON, DC

Mr. GORDON. Thank you, Mr. Chairman and Members of the Committee. I am appearing on behalf of the National Retiree Legislative Network, which is a kind of unique grassroots retiree organization that formed recently out of concerns about the potential threat to not only their pensions caused by the presence of some of these suddenly underfunded plans, but also by—their concerns are magnified, really, by the continuing loss of their retiree health benefits, which are not protected like pensions under ERISA, and which forces many of them to raid their pensions to pay the health bills their employees no longer pay.

Indeed, the pending Medicare legislation will probably make this problem worse, by encouraging employers to drop their drug programs and shift these retirees into an inferior drug program which—where they will have to raid their pensions even more to cover their drug costs, which are not being picked up by either their employer or Medicare.

Of course, if their pensions are watered down because of inadequate funding and an inadequate PBGC back-up, we will have an old-age disaster on our hands not experienced since the Great Depression.

We believe, therefore, that, yes, we do need a comprehensive approach to these funding problems, and you're going to probably hear that word until it comes out of your ears.

We think that it is necessary because of the contracting nature of the defined benefit plan universe, a situation which did not exist when ERISA was enacted, and the funding rules were put into place, and probably wasn't even perceived in 1994, when the deficit reduction rules were put in, that we need to take a completely fresh look at this situation.

We think that only a comprehensive approach will work now, and we think that the situation which requires a comprehensive approach is exacerbated by the pathology of a number of industries such as steel and airlines, where there is also severe pension underfunding, also a situation which didn't exist when ERISA's funding rules and PBGC rules were put into effect.

So, we have a new ball game, in our opinion, and we have to confront it head on. We believe that the temporary switch to the corporate bond discount rate is counter-productive. We know that the House passed it, we understand it, but we think that the resolution of the discount rate issue should be part and parcel of a comprehensive approach, and not the other way around.

Even assuming that continuing to use a modified Treasury bond rate is no longer feasible, we think that the case for switching to a corporate rate has not been made since, as GAO has indicated in its report in February, there are major problems of transparency and selectivity in adopting a corporate bond rate.

Therefore, this is not just a question of moving from an artificially low rate—arguably artificially low rate—to a more moderate rate, but one that also involves the reliability of the corporate bond rate.

We believe that there ought to be another extension of the modified Treasury rate, with perhaps some minor tweaking of the upper limit there, of 120 percent.

We believe that the chief target of a comprehensive approach should be reforming the deficit reduction rules. We suggest that a funding waiver procedure be adopted that relieves the stress businesses feel from having to make catch-up contributions if they agree to essentially freeze accruals for anyone except older service employees, stop lump sums, undergo stiffer fiduciary and independent actuarial supervision, and a few other things that are detailed in our testimony, written testimony, on page seven.

We think that that is the first place to attack this problem, and it will balance off the interests of protecting PBGC's fiscal integrity, while at the same time not squeezing employers who are under stress to the point where the situation really becomes worse, rather than better.

Finally, we think that a special PBGC insurance fund, high-risk fund, with tighter rules and higher premium schedules, is necessary for distressed industry plans like steel and airlines. These plans should no longer be regulated on just a plan-by-plan basis. And just looking at them through the prism of their specific funding situation, without taking account of what's going on in the industry that surrounds them, we think, is being myopic.

We think that there should be special rules for these programs, special premiums for these programs, special oversight for these programs, and particularly, an all-new approach to not forcing employers and healthy industry plans who are doing a good funding job, having to continue to subsidize these distressed industry plans which, whatever they try to do, however hard they try to do it, are not going to come up to snuff for quite some time.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Gordon follows:]

Statement of Michael S. Gordon, General Counsel, National Retiree Legislative Network, Inc., Washington, DC

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to present this testimony on ERISA funding issues on behalf of the National Retiree Legislative Network, Inc. (NRLN). NRLN is a unique Washington, D.C. based grassroots retiree organization that was started a little over two years ago by a number of large company retiree groups alarmed over increasing threats to the preservation of their health and pension benefits. NRLN represents nearly 2 million retirees from the Association of BellTel Retirees, Association of U.S. West Retirees, Prudential Retirees, Monsanto Retirees, Raytheon Retirees, along with groups from Boeing, General Electric, General Motors, IBM, Johns Manville, Lucent, Southern New England Telephone (SNET), Portland Electric (Enron), Western Union and many others.[1]

For reasons that will be described shortly, from the outset NRLN has opposed temporarily changing the discount rate used to calculate defined benefit plan pension liabilities from the current modified 30-year Treasury bond rate to a composite corporate bond rate. Notwithstanding the recent House action of October 8 approving the 2-year use of a corporate bond rate, NRLN remains opposed to this switch.

Concisely stated, NRLN's position is that we are in the midst of the greatest pension underfunding crisis since ERISA was enacted almost 30 years ago. In these circumstances, piecemeal measures, like the corporate bond discount rate fix, will not make matters better, and probably will make them worse.

NRLN believes that only a comprehensive approach that is grounded in ERISA's core principles will overcome this crisis and provide both needed flexibility to defined benefit plan sponsors as well as adequate protection to defined benefit plan beneficiaries. In addition, only a comprehensive approach will prevent a potential meltdown of the Pension Benefit Guaranty Corporation and a savings-and-loan type rescue mission at taxpayer expense.

Moreover, those on this Committee, and those in the Congress, who believe that granting a temporary 2-year corporate bond discount favor to defined benefit plan sponsors will create pressure for a more comprehensive solution have got it backwards. Instead, it will create pressure for more and more quick fixes while a genuine comprehensive and principled solution becomes ever more elusive. The rather uninspiring history of the modified 30-year Treasury bond discount rate due to expire at the end of this year supports this view, and some brief attention must be paid to it in order to appreciate NRLN's concerns.

The Discount Rate Controversy

The current modified 30-year Treasury bond discount rate originated in the Job Creation and Work Assistance Act of 2002, which was signed into law by President Bush on March 9, 2002. The main purpose of this $42 billion bill was to provide tax breaks aimed at spurring business investment and to extend unemployment compensation for individuals who had exhausted their existing benefits. In short, it was intended to stimulate the economy.

The bill included a temporary pension funding relief measure focused on inclusion of the Treasury discount rate in question. This action was based on the assertion that the 30-year Treasury rate was artificially low (especially after Treasury stopped issuing 30-year bonds) and, therefore, forced plan sponsor to make unnecessarily higher contributions to their pension plans by exaggerating the amount of liabilities that had to be funded.

Even then, however, the companies seeking this relief claimed that it was more appropriate to calculate liabilities by using a long-term high-quality corporate bond discount rate rather than the modified Treasury bond rate. That view was rejected by Congress in 2002 and all sides agreed that the entire issue would be studied during the temporary relief period, with the aim of securing a permanent solution by the time the temporary relief period expired at the end of 2003.

As the end of 2003 approaches, do we have such a permanent solution? No, as far as the House is concerned we have another 2-year temporary solution, only this time the companies have achieved in 2003 what they could not achieve in 2002—a temporary switch to a corporate bond discount rate and the abolition of the modified Treasury bond rate.

Was this switch to a corporate bond rate the product of any independent, non-self-serving study performed after March 2002? Not as far as we know. In fact, in February, 2003, GAO issued a report containing explicit warnings against use of a corporate bond rate. The GAO report identified problems of transparency and methodology involving the construction of corporate bond rates. See GAO–03–313.

In view of this history, it is unlikely that the House adoption of the 2-year corporate bond rate will encourage a definitive ERISA funding study. Instead, it can be safely predicted that this politically expedient temporizing process will be re-

[1] For more on NRLN, visit its website, www.NRLN.org.

peated indefinitely until either the economy takes off and companies are less concerned about making funding contributions, or PBGC collapses. In case of the latter, the advocates of these temporary fixes will probably say—no doubt with the utmost sincerity—that it would have happened sooner absent the temporary fixes.

Stepping aside momentarily from the pro's and con's of the corporate bond rate switch, what is more significant is the failure of both the Congress and the Administration to get on top of the real problem sooner. The real problem has very little to do with the discount rate and tinkering with it so that many companies can take undeserved funding holidays is tantamount to playing Russian roulette with defined benefit plan pensions.

The Real Problem

The real problem is that the defined benefit plan universe that existed when ERISA's funding and plan termination insurance provisions were first enacted no longer exists. Indeed, it probably had stopped existing when the Retirement Protection Act of 1994 (RPA) was enacted but that development may not have been as apparent then as it is now. RPA, of course, substantially toughened the funding rules for underfunded single-employer defined benefit plans by, among other things, imposing certain deficit reduction or "catch-up" contribution requirements on plans whose current liability was less than 90% funded.

It is unlikely that the defined benefit plan universe will ever return to anything resembling its former self. These plans were primarily a creature of the manufacturing industry which has suffered a sharp and probably irreversible decline. They also tend to be not well-suited for use by the services industry which is now, and for the foreseeable future, in the ascendancy.

Furthermore, these plans have also lost ground because of the decline of the trade unions. They will persist mainly in those sectors of the economy where unions are influential, but those sectors are shrinking as well.

Moreover, structural changes in the Nation's economy make traditional defined benefit plans unappealing to many employers and employees alike. Due primarily to the telecommunications and Internet revolution, a long-serving permanent workforce does not now fit the business model of many companies regardless of their earlier histories.

As a corollary, employees who do not expect to spend all or most of their working careers with one or two employers want pension plans that provide quick results, usually in the form of lump sum payments when they exit a particular company after only several years of work. In combination, these forces have sapped the historic mission of defined benefit plans which was to provide past service credit for older workers (i.e., credit for service performed before the inception of the plan or before an amendment improving benefit levels was adopted).

In this regard its needs to be recalled that prior to ERISA employers were only compelled to make annual contributions to cover the interest costs on these past service liabilities and were not required to fund the liabilities themselves (i.e., the principal). It was because of this regulatory deficiency that the pre–ERISA funding disasters arose and it was this deficiency that the ERISA funding—PBGC system was designed to correct.

Finally, to make matters worse, another problem that did not exist when ERISA's funding standards (including its most recent refinements) were under consideration, is that there are just not more numerous underfunded plans but there are several sick industries with mostly underfunded plans. This problem has begun to assume critical importance because up to now the entire funding—PBGC regime has been centered on treating the defined benefit plan sponsor as a fully autonomous funding decision-maker in which considerations relating to specific industries or national security were irrelevant.

Because of the developments just described it should be plain that a major overhaul of the ERISA funding and PBGC apparatus is needed. ERISA was enacted on the premise of a constantly expanding defined benefit plan universe in which only individual employers got sick not entire industries. Just the reverse is true today and we need to adapt to this new reality with all deliberate speed.

Priorities

In order to pull together a new funding-PBGC policy for an ever-contracting defined benefit pension world, it is necessary to have some sense of the priorities that should guide such an effort. From our standpoint, the most important priority, the one to which all others must yield, is assuring the protection of those who are most vulnerable to the loss or reduction of their precious pensions.

This means that legislative revisions to the current funding—PBGC framework must guarantee that existing retirees and older workers with substantial service are protected in their full pension expectations to the maximum feasible extent. Some employers refer euphemistically, and perhaps disdainfully, to these earned pensions, as "legacy costs". But behind each of these so-called "legacy costs" is a human being whose life was committed to faithful service with the employer and whose life would be ruined if his or her pension was gutted. Nothing will more quickly undermine the legitimacy of new funding—PBGC reforms than the perception that they have been structured so that companies can shed their financial obligations to these beneficiaries.

The next priority is to redesign the funding—PBGC rules so that the business prospects of companies with underfunded plans are not irreparably threatened by the inflexible application of these rules. At the same time, we must assure that any additional funding flexibility provided to business does not end up threatening the fiscal integrity of PBGC. We have some specific recommendations below on how to balance these two objectives.

The remaining priority that we would like to emphasize is that funding—PBGC revisions must be accompanied by an upgrading of the administration of the remaining defined benefit pension plans. No one really understands how plans that were swimming in huge pension surpluses just a few years ago suddenly became so monumentally underfunded. Furthermore, no one really understands how or why some of the same companies whose pension plans went from overfunded to underfunded so quickly were still rewarding their top executives with increased compensation, including juicy cash bonuses and stock options.

From where we stand, blaming the funding entirely on the economy doesn't quite add up. We think this experience signals the need for tighter fiduciary oversight and we have a number of specific recommendations in this area as well.

Recommendations

1. The first step—one that is needed to restore credibility to this funding—PBGC overhaul process—is to withdraw the 2-year temporary use of corporate bond discount rates which the House approved. This decision by the House lacks the authoritative quality that should be associated with a decision of this kind.

We agree that there is a need to avoid subjecting business to unrealistic funding rules, but the source of the problem is not the use of the modified Treasury rate but rather the funding rules themselves. It is these rules, principally the deficit reduction contribution rules imposed by the RPA, which need adjustment.

In the meantime, we recommend that the modified Treasury rate be extended for another year, with perhaps a slight extension of the upper limit of the permissible range of the weighted average of the interest rates on 30-year Treasuries, which is now at 120 percent. Since it cannot be claimed that all defined benefit plan sponsors are in desperate need of temporary funding relief, our proposal would represent a principled approach to the issue and would avoid the impression that all Congress is interested in doing is giving defined benefit plan sponsors the economic equivalent of a tax break via a questionable corporate bond rate formula.

We are equally unpersuaded that adopting a "yield curve" approach, as proposed by the Treasury, is the best option for the future. There is no automatic correlation between ostensibly adverse plan demographics (e.g., higher proportion of retirees to actives) and a given employer's ability to discharge its future retirement benefit obligations. Indeed, in some cases the appearance of adverse demographics may be deceiving in that the installation of labor-saving devices may have made the company more productive and profitable and more capable of discharging its future obligations.

Without attempting to detract from the seriousness of funding problems confronted by companies or potentially explosive demographic issues confronted by PBGC, the establishment of a permanent discount rate replacement for the 30-year Treasury rate should be governed by purely objective criteria relating to the general domestic economic universe. Only in that way can more integrated measures be taken to address the fundamental funding issues involved.

2. The most important step is to tackle the real source of the trouble, the deficit reduction or "catch-up" rules. These rules were enacted in 1994 when PBGC's single-employer fund was deeply in the red and there was fear of a savings-and-loan type calamity overtaking the agency.

Whatever their virtues in theory, in practice these RPA rules place inordinate demands on those employers whose businesses are suffering at the very time that their defined benefit plans are falling below the 90 percent of liabilities funding test. Moreover, RPA fails to provide any direct funding variance relief procedure to employers who, for reasons of business hardship, are unable to come up with the contributions to satisfy the 90 percent test.

Without attempting to describe an exhaustive set of possible revisions, and bearing in mind the social policy priorities previously discussed, we propose that employers that cannot meet the 90 percent requirement because of demonstrable business hardship, be given a special funding waiver for an appropriate period provided that they: (a) stop all lump sum payments, (b) freeze all future accruals for employees with less than 10 years of service; (c) refrain from any further benefit improvements, (d) suspend any benefit improvements made within 3 years of the application for a waiver, (e) agree to a special future experience-rated premium increase on terms satisfactory to PBGC, and (f) become subject to special monitoring and disclosure requirements during the period of waiver.

Some of the foregoing resembles the "reorganization" requirements now in effect for multiemployer plans. See Internal Revenue Code section 418. However, even these rules may have to be reevaluated under current circumstances. In addition, the legal requirements concerning "partial terminations" may have to be rewritten.

For employers that cannot meet the 90 percent requirement and are members of "sick" industries (e.g., steel, airlines), additional precautions should be taken. Employers with reasonably healthy plans in reasonably healthy industries (at least as indicated by their overall demographics) should not be dragged down by having to increase their PBGC premium subsidization of these "sick" industry plans. Plans in these "sick" industries should pay higher PBGC premiums regardless of whether they meet the 90 percent test and should be subject to more intense scrutiny.

It may be more efficient to spin off these "sick" industry plans into a special high-risk PBGC guarantee fund that has its own special rules. Whether the federal government should also provide some form of direct assistance to help stabilize these plans is beyond the scope of this testimony, but may warrant further study, especially in the case of industries that impact national security.

3. Hand-in-hand with rearranging the "deficit reduction" requirements, it is also imperative to increase fiduciary oversight of plan sponsors who seek hardship relief from the 90 percent rule. It would be appalling to grant such relief without determining first whether the applicant made prudent investment decisions on behalf of the plan and whether the plan fiduciaries acted prudently in approving the actuarial assumptions used under the plan.

These are not trivial matters. There is a strong evidence, for example, that many of the plans now in funding trouble used much too high investment earnings assumptions and are still using them. Several months ago, NRLN urged the Secretary of Labor to conduct a thorough investigation of this subject and, as of this date, has not even received the courtesy of an acknowledgement letter.

Any plan that seeks funding relief of the type outlined above should be compelled to have all of its actuarial assumptions, including its earnings assumptions, certified to by an actuary independent of the plan's actuary. In addition, any plan seeking such relief should be compelled to submit a report by an independent investment manager or fiduciary concerning the adequacy of the investment policies followed by the plan during the prior 5 years. Only in this way can we assure the integrity of the ERISA funding process and get private sector defined benefit plans back on the right track.

Conclusion

The recommendations discussed above merely scratch the surface of policy options that Congress needs to consider to ensure that the defined-benefit plan system weathers the current underfunding storm and that both the most vulnerable beneficiaries and the most vulnerable employers, as well as the PBGC, are adequately protected. NRLN urges this Committee to continue its active exploration of these problems and provide the leadership essential to resolve them in a more satisfactory way. Do not leave these problems unattended; they will only get worse.

Chairman BOEHNER. Thank you, Mr. Gordon.

Mr. Iwry?

STATEMENT OF J. MARK IWRY, ESQ., NON-RESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. IWRY. Thank you, Mr. Chairman. After spending much of the previous decade in the Treasury Department, overseeing the regulation of defined benefit and defined contribution retirement plans and other benefits, and after participating in the effort 10 years ago to reform the pension funding rules and shore up the PBGC's financial situation, I am convinced that there is no simple solution here. There is no silver bullet, because of the obvious need to reconcile a number of legitimate interests that are intertwined with one another.

And first and foremost, there is the interest of employees in actually getting the benefits promised to them, for which they previously gave up current wages, as well as employees' interest in having employers stay in the game, having employers continue to sponsor employer-funded plans, and employees' interest in not having funding obligations push their employer over the edge, financially.

Second, there is the interest of financially strong employers in not having to excessively subsidize weak employers through undue levels of PBGC premiums, or otherwise, and the interest of financially strong employers in keeping their funding obligations predictable.

Third, the interest of financially troubled plan sponsors in predictable funding obligations that don't push them into bankruptcy.

And finally, the interest of taxpayers in avoiding a large, unexpected bill, or a deeper budget deficit in order to help PBGC pay unfunded benefits.

That said, I have several recommendations. Congress needs to begin by enacting a short-term replacement of the 30-year Treasury interest rate without going too far to compromise responsible funding in the long term, and without going so far as to tie its own hands, or narrow its own options, with respect to the more comprehensive phase of reform that you're about to consider.

At the same time, Congress has to take into account the potential impact of large funding demands on plan sponsors and an industry's financial situation, and on economic growth, and has to balance that against the need for adequate funding over the long term, the need to eliminate chronic underfunding, and the need to minimize volatility for plan sponsors, so that increases in funding from year to year stay on a reasonably smooth, predictable path.

Once it puts a temporary fix in place, Congress will be able to turn its attention back to working with the executive branch and stakeholders to develop a common understanding of where we are, and what needs to be done to reform the system. And this hearing is a constructive part of that process.

To that end, I hope that a bipartisan approach and a transparent approach will be followed, and that the executive branch will not only allow, but direct the PBGC to share with Congress and with the premium-paying plan sponsors and the plan participants all of its data and modeling to the extent that it would not compromise confidential information, to the extent that it would not disclose information regarding particular companies.

But with that constraint, share the numbers, the assumptions, the methods that it uses to estimate the effect of alternative funding policies, and also to estimate its own financial situation, to project its liabilities, to take into account assets that it will recover from future plan terminations, and that it will do so in an open and transparent manner.

Specifically, we need to strengthen the deficit reduction contribution, as others have suggested, and make it less volatile. As you know, this is an accelerated funding requirement that has not kicked in soon enough in many cases, and that has shut off too quickly in other cases.

We need to address the rules concerning credit balances and other methods that companies have had of avoiding contributions at times when they really should be contributing, and Bethlehem Steel is a case in point—contribution holidays at times when the plan is really becoming dangerously underfunded.

We need better disclosure on the funding status of plans, improving both the transparency and the timeliness of disclosure. We need to allow companies to fund for lump sum distributions, even when the value of those exceeds the value of annuities, which the IRS does not let them do today.

And revised rules have to continue to protect the reasonable expectations of employees and retirees with respect to promised benefits. And, to the extent possible, continue to encourage employers to provide pensions and maintain plans. Restricting benefits or benefit improvements should be a last resort, as should curtailing the PBGC's guarantee.

As a final point, though, Mr. Chairman, as you know, a major portion of the DB universe now consists of cash balance and other hybrid plans. I suggest that as part of this overall strategy toward defined benefit plans, the system would benefit from a resolution of the cash balance controversy by Congress, working with Treasury and the other agencies, to settle the law governing these plans in a reasonable way, giving older workers substantial protection from the adverse affects of a conversion, and allowing companies to maintain the plans free of concern that they be held to be age-discriminatory, and with reasonable flexibility to change the plans going forward, including to make cash balance conversions.

I would be happy to answer any questions that you or the members of the Committee might have.

[The prepared statement of Mr. Iwry follows:]

Statement of J. Mark Iwry [1], Esq., Non–Resident Senior Fellow, The Brookings Institute, Washington, DC

Chairman Boehner, Ranking Member Miller and Members of the Committee, I appreciate the opportunity to appear before you to discuss issues relating to underfunding in our private defined benefit pension system and pension funding reforms.[2]

After providing brief background on defined benefit plans, pension insurance, the PBGC, and the taxpayers' investment in the private pension system (part I, pages 1–4 and Appendix A), this written statement reviews recent developments affecting pension funding and pension insurance (part II, pages 4–7) and the often conflicting public policy objectives that need to be reconciled when formulating policy in this area (part III, pages 7–8). Next, the statement turns to two threshold questions—whether legislation is needed in the short term and whether broader, permanent changes to the system are called for (part IV, pages 8–9). The main portion of the testimony then suggests ten specific cautions and considerations to bear in mind when considering longer-term reforms (part V, pages 9–17).

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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] The majority of this testimony is drawn verbatim from my September 15, 2003 testimony before the Subcommittee on Financial Management, the Budget, and International Security of the U. S. Senate Committee on Governmental Affairs. Several portions of the September 15, 2003 testimony draw heavily, in turn, on my previous testimony regarding the same or similar issues.

I. BACKGROUND [3]

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. The PBGC's guarantee generally applies when the plan terminates while inadequately funded and the plan sponsor has failed or is otherwise demonstrably unable to make up the deficiency. PBGC guarantees more than 32,000 defined benefit plans that are sponsored by private-sector employers and that cover nearly 44 million workers and retirees.

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 and significantly less for pensions beginning earlier). If a defined benefit plan terminates without adequate funding to pay promised benefits, and the employer goes out of business or is otherwise financially unable to fund the benefits (a "distress termination"), 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 termination, the plan sponsor and its affiliates are liable to PBGC for unfunded liabilities, and 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, PBGC operates as an insurance company for pension plans. However, it has a special public responsibility to protect the interests of plan participants in a social insurance system. 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.

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 separate programs correspond to the somewhat different legal frameworks that apply to the two types of plan.

- "Single employer plans" include the conventional corporate plan sponsored by a single employer for its employees (as well as a plan sponsored by several related employers where the joint sponsorship is not pursuant to collective bargaining).
- "Multiemployer plans" are 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.

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. However, those plans generally are 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 sources of funding are

- the premiums it collects,
- assets obtained from terminated plans PBGC takes over,
- recoveries in bankruptcy from former plan sponsors, and
- earnings on the investment of PBGC's assets.

General tax revenues are not used to finance PBGC, and PBGC is not backed by the full faith and credit of the United States Government. The U. S. Government is not liable for any liability incurred by PBGC.

[3] Further context regarding the private pension system is provided in Appendix A, which is drawn nearly verbatim from my June 4, 2003 testimony before this Committee's Subcommittee on Employer Employee Relations.

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.[4] 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).[5]

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.[6] 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, 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 (the amount by which assets exceeded liabilities) was in the neighborhood of $10 billion. Recently, however, PBGC has seen the financial condition of its single-employer program suddenly return to substantial deficit: $3.6 billion in fiscal year 2002 and, according to PBGC, an estimated $8.8 billion as of August 31, 2003 (based on PBGC's latest unaudited financial report). [7]

PBGC's financial condition could alternatively be expressed in percent funded terms—taking PBGC's assets as a percentage of its liabilities. For the purpose of estimating PBGC's funding percentage, it has been suggested that, when PBGC takes into account "probable" future claims, it count not only expected total liabilities but the total assets PBGC would be expected to take over and recover in connection with those claims.

PBGC's financial condition has deteriorated because a number of major plan sponsors in financial distress have terminated their defined benefit plans while severely underfunded. Others may well follow suit. In addition to structural weakness in certain industries, 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 contributed dramatically to the underfunding problem.

According to PBGC estimates, 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 were to terminate. (About half of the $35 billion is attributable to plans in the steel and air transportation industries.) 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.[8] PBGC also expects that, by the end of fiscal year 2003, its

[4] 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.

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

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

[7] Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Special Committee on Aging, United States Senate, October 14, 2003 ("PBGC October 14, 2003 Testimony"), page 3.

[8] 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—about $2.5 billion in fiscal year 2003, and expected to increase to nearly $3 billion in fiscal year 2004—which are partially offset by premium income that is somewhat less than $1 billion a year.

estimate of underfunding in financially troubled companies will have grown from $35 billion to more than $80 billion.[9]

To help put the amounts into perspective, the total amount of defined benefit 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 (fiscal year 2002) and $80 billion (fiscal year 2003) figures cited earlier represent estimated underfunding in plans sponsored by financially troubled companies (where PBGC estimates that plan termination is "reasonably possible)."

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. Together, these two industries account for nearly three fourths of all past claims on the PBGC while representing fewer than 5% of participants covered by PBGC.[10] For example, in 2002, PBGC involuntarily terminated a plan of Bethlehem Steel Corporation that shifted about $3.7 billion of unfunded liabilities to 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 worker spent 11.5 years in retirement in 1950, compared to 18.1 years today.[11] Of course longer retirements increase plan liabilities because the life annuities provided by defined benefit plans are paid for a longer period.

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. (A number of the major factors accounting for the decline are discussed in my June 4, 2003 testimony before this Committee's 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 financially troubled companies adding benefits that they know may well be paid by PBGC. This risk grows as the premium base narrows and as financially strong sponsors find their premiums are increasingly subsidizing the financially weak employers that pose the risk of underfunded plan terminations imposing liability on 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.

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[9] PBGC October 14, 2003 Testimony, page 7.

[10] Most of the financial data in this testimony regarding PBGC and its exposure are from recent PBGC testimony: Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Special Committee on Aging, U.S. Senate, October 14, 2003, and Mr. Kandarian's testimony before this Committee's Employer–Employee Relations Subcommittee on September 4, 2003.

[11] See testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation before the House Committee on Ways and Means, Subcommittee on Select Revenue Measures, April 30, 2003, pages 7–8.

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 now have underfunding 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 no longer is only a pension policy problem; it has become a larger industrial and social policy problem.

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—unexpectedly 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.[12] 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 reconciled or 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—who are subsidizing the sponsors of underfunded plans—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, including the long-term impact that extends beyond the conventional budget "window".

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 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 for employers enacted for 2002 and 2003 in the Job Creation and Worker Assistance Act of 2002—allowing plan sponsors to in-

[12] For an evaluation of defined benefit plans from a pension policy standpoint, a discussion of the role of these plans in the private pension system, and an analysis of the decline in defined benefit coverage, see Testimony of J. Mark Iwry before this Committee's Subcommittee on Employer–Employee Relations, June 4, 2003, as well as the testimony of other witnesses presented at a hearing of the Subcommittee on that date.

crease their pension funding discount rate from 105% to 120% of the four-year weighted average of the 30-year Treasury rate—should not be allowed to expire at the end of 2003 without an appropriate legislative replacement.

Earlier this month, the House passed H.R. 3108 (the "Pension Funding Equity Act of 2003", sponsored by Chairman Boehner and cosponsored by Ranking Member Miller and Rep. Johnson of this Committee), which would not only continue the temporary funding relief but expand it significantly. For purposes of determining the pension funding discount rate (and PBGC variable-rate premiums) for 2004 and 2005, the bill would replace 105% of the four-year average of the 30-year Treasury rate with the four-year average of interest rates on amounts conservatively invested in a blend of long-term corporate bonds.

The Senate Finance Committee has reported out a bill (the National Employee Savings and Trust Equity Guarantee Act, or "NESTEG") that includes a similar change not only for 2004 and 2005 but also for 2006, and that would go much further in other respects.[13] In addition to proposing certain more permanent changes to the funding rules, NESTEG would waive the "deficit reduction contribution" ("DRC") requirement for 2004–2006 for any plan for which a DRC was not required for the 2000 plan year. The DRC, which calls for accelerated funding of plans that are essentially less than 90% funded, is the linchpin of the funding requirements for underfunded plans and of the 1987 and 1994 pension funding reforms.

The Administration has objected strongly to this proposed three-year waiver of the DRC[14] (which is not included in the legislation passed by the House) on the ground that it would expose workers and the PBGC to unnecessary risk of underfunding in the highest-risk plans. As originally contemplated, the provision would have applied to a more narrowly defined set of plans, but the proposal was expanded to include all plans for which a DRC was not required in 2000. According to PBGC, nearly 90% of the underfunded plans that have actually terminated since 2000—the very riskiest category of plans—would be able to take advantage of this proposed DRC waiver if they were still in existence, because they, like most major plans, were not subject to the DRC in 2000.[15]

PBGC estimates that the three-year DRC waiver would increase underfunding by $40 billion. It estimates that the proposal would allow cessation of accelerated funding by the corporations that represent close to $60 billion of the estimated total of $80 billion of underfunding in plans sponsored by financially weak employers.[16]

A three-year waiver of the DRC for most underfunded plans would have broad ramifications. While focusing on potential replacements for the 30-year Treasury discount rate—particularly the use of a single corporate bond rate versus a yield curve—Congress has not given close attention to a possible DRC waiver, which could go as far or further to perpetuate or expand underfunding.

It is entirely appropriate to take short-term financial distress into account when considering pension funding policy. However, in order to strike a reasonable balance between competing policy objectives, exceptions need to be studied thoroughly, crafted narrowly to avoid compromising adequate funding in the longer term, and considered in the context of other possible changes designed to ensure adequate long-term pension funding.

A second threshold question is whether other, permanent changes should be made to the defined benefit funding and insurance system. Here too, Congress needs to act soon, 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 so 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 ten specific cautions and considerations.

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[13] As of the date of this hearing, the Senate Health, Education, Labor, and Pensions Committee is scheduled to mark up a bill that would also provide short-term pension funding relief.
[14] PBGC October 14, 2003 Testimony, page 10.
[15] Ibid.
[16] Ibid.

A. Protect Plan Sponsors 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 that would 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 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 financially strong 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 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 PBGC has observed that a large proportion of the sponsors that have shifted their obligations to 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'[17] (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 reports 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 PBGC takes over a terminating plan, the employer typically has become insolvent or at least has "downsized" significantly.

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[17] 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.

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 PBGC on a confidential basis.[18]

Improved transparency and disclosure is desirable. 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 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 Fullest 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." [19] 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 often have been reluctant to contribute too much to collectively bargained plans out of concern that the unions will demand that any resulting surplus be converted to higher benefits.

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.[20] Thus, continued accruals, lump sum distributions of more than $5,000, and benefit improvements would be prohibited unless fully funded by the employer.

These proposals—particularly a freeze of benefit accruals—should be viewed with caution. 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.

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.

[18] Generally similar requirements have been proposed in H.R. 3005, the "Pension Security Disclosure Act of 2003," introduced by Rep. Doggett and Ranking Member Miller.

[19] Combs testimony, pages 6–7.

[20] 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.

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. It can be argued, therefore, that hourly plan benefit improvements, to the extent they do not exceed an amount that reasonably serves this regular 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 fact that 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. The five-year phasein provides PBGC with some protection (though far from complete) from claims attributable to benefit improvements that are granted during a corporate "death spiral" before the plan terminates and is taken over by PBGC.

Third, formulation of policy here should take into account the fact that the employees participating in underfunded plans have already given up a portion of their wages in exchange for the promised benefits and generally do not control either the funding of the plan or their employer's financial condition. To what extent should employees 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. (Others would contend that such restrictions would unduly interfere with collective bargaining as well.) Of course such concerns would be even more applicable to 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 Single–Sum Benefits

Current IRS rules restrict the ability of a defined benefit plan sponsor to fund based on expected future single-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 and adequate funding, the rules should allow employers to anticipate funding obligations associated with expected single 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 any particular employee, however, the determination of the amount of that individual's pension ordinarily is a one-time, irrevocable event, especially in the case of a single-sum distribution. If, for example, Congress gave employers funding relief in the short term by increasing the funding discount rate, and also applied a higher discount rate to the calculation of single-sum benefits in a way that unduly reduced their value, employees who received those reduced single-sum benefits during such 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 an individual who received a reduced pension benefit 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. As in the past, determining the appropriate discount rates for funding and for single-sum distributions entails two different, albeit related, analyses involving two different sets of considerations.

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, as a general matter, stocks traditionally have been expected to generate higher 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 Guided By the Numbers

It is worth bearing in mind the obvious: funding discount rates and other pension funding rules do not directly determine the magnitude of a plan's actual liabilities to pay benefits. Instead, in the first instance the funding rules affect when and how much a company pays into the plan to prefund those liabilities. Accordingly, since funding policy is ultimately a matter of dollars over time, it should be informed by the numbers, rather than focusing on abstract propositions or on doctrinal positions regarding particular elements of funding whose consequences depend on interactions with other elements.

Policymakers in Congress and the Executive Branch need specific data and modeling to help them weigh the likely impact of alternative policies on the funded status of plans. Given particular rules, how many dollars will go into plans and when? The necessary data and analysis are extensive, in part because they must focus on particular industries and even on those specific companies and plans that are large enough to have a material impact on overall policy and on PBGC's financial condition.

Therefore, as Congress approaches the end of the first phase of this policy process—devising a short-term fix—and turns its attention to the next phase—more comprehensive, permanent reform—it needs the active cooperation of the Executive Branch to give it access to the best available data, analysis and modeling. "Number crunching" is essential to responsible policymaking in the pension funding area. Transparency of analysis—sharing of data and modeling capability by the PBGC, the plan sponsor community, their professional advisers, and others—will be important in the coming months. Of course, the process must carefully protect proprietary and other confidential or sensitive information specific to individual employers, including taxpayer confidential information.

I. 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. It generally is preferable to consider possible long-term 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. An effort to smooth in one place, for example, might interact with other rules so as to create sharp discontinuities elsewhere.

J. 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 share certain 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.

Like the regulation of pension funding, the regulation of cash balance plans has potentially far-reaching consequences for the survival of the defined benefit system and for workers' retirement security. The system as a whole would benefit from a resolution of the cash balance controversy that would settle the law governing those plans in a reasonable way. While testifying in June before this Committee's Subcommittee on Employer–Employee Relations, I expressed the view, in response to a question from a Subcommittee Member, that Congress could resolve the cash balance issue in a manner that provides substantial protection to older workers from the adverse effects of a conversion while allowing employers reasonable flexibility to change their plans. At the Subcommittee's request, I submitted additional written testimony illustrating such a legislative approach.[21] If any Member of this Committee is interested, I would be happy to discuss this issue further.

Mr. Chairman and Ranking Member Miller, I would be pleased to respond to any questions you and the Members of the Committee might have.

Appendix A - More Context Regarding the Private Pension System

In assessing our nation's private pension system, one can readily conclude that the glass is half full and the glass is half empty. The system has been highly successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding $5.6 trillion (excluding IRAs) that has been instrumental in promoting the growth of our economy [22].

Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.[23] However, the benefits earned by many are quite small relative to retirement security needs. Moreover, moderate- and lower-income households are disproportionately represented among the roughly 75 million working Americans who are excluded from the system. They are far less likely to be covered by a retirement plan.[24] When they are covered, they are likely to have disproportionately

[21] 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.

[22] Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 6, 2003), tables L.119, 120. This total is as of the end of 2002. It excludes amounts rolled over from plans to IRAs as well as other IRA balances. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Engen, Eric and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (October 2000) ("Engen and Gale 2000").

[23] Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate (Sept. 21, 1999)("Sept. 21, 1999 Testimony").

[24] It has been estimated that over 80% of individuals with earnings over $50,000 a year are covered by an employer retirement plan, while fewer than 40% of individuals with incomes

Continued

small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.) Accordingly, the distribution of benefits—retirement benefits and associated tax benefits—by income is tilted upwards.

Yet providing retirement security for moderate- and lower-income workers—in other words, for those who need it most—should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement affluence—minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.[25] It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts, direct to tax-favored accounts current income that would otherwise be saved in nontax-favored vehicles, or offset additional contributions with increased borrowing. But contributions and saving incentives targeted to moderate- and lower-income workers—households that have little if any other savings that could be shifted—tend to increase net long-term saving.[26] This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

These goals have been articulated by the Department of the Treasury in congressional testimony as follows:

> "First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving...
>
> "Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security".
>
> "Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?"[27]

There are a number of reasons why the system is not doing more to address the needs of moderate- and lower-income workers.

First, tax incentives—the "juice" in our private pension system—are structured in such a way that they prove to be of little if any value to lower-income households. Workers who pay payroll taxes but no income taxes or income taxes at a low marginal rate derive little or no value from an exclusion from income for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings, or from a tax deduction for plan contributions. Roughly three quarters of our population are in the 15%, 10% or zero income tax brackets. (Refundable tax credits—or even currently nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions (as well as voluntary employee contributions to defined benefit plans) under section 25B of the Internal Revenue Code—would help address this problem.)

Second, obviously, after spending a higher proportion of their income on immediate necessities such as food and shelter, lower-income families often have little if anything left over to save.

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under $25,000 a year are covered by an employer retirement plan. See Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, before the House Committee on Ways and Means, Subcommittee on Oversight, page 6 (March 23, 1999) ("March 23, 1999 Testimony").

[25] March 23, 1999 Testimony, page 3.

[26] See Engen and Gale (2000).

[27] March 23, 1999 Testimony, pages 3–4.

Third, lower-income families have less access to financial markets, credit and investments, and tend to have little if any experience with tax-advantaged financial products, investing and private financial institutions.

Fourth, the qualified plan rules permit many moderate- and lower-income workers to be excluded from coverage. The rules provide considerable leeway with respect to proportional coverage of moderate- and lower-income employees, and do not require any coverage of millions of workers whose work arrangements are part-time, based on independent contractor status, contingent or otherwise irregular.

Appendix B - A 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.

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 pension funding 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.

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. In 1987 and 1994, political pressures and other constraints prevented the accomplishment of all that was needed to reform the system. Meanwhile, the stakes have gotten higher. Over the past decade, the scope of the funding problem has expanded, largely because of the structural industry-wide and demographic developments outlined earlier. Congress and the Executive Branch now confront the challenge of drawing the appropriate lessons from 1994 and the ensuing decade of experience, and completing the unfinished business of reforming the pension funding system.

Chairman BOEHNER. Thank you, Mr. Iwry, for your testimony.

Mr. John?

STATEMENT OF DAVID C. JOHN, RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. JOHN. Thank you for inviting me to testify today on a problem that is growing in importance, and growing, I'm afraid, in emotion.

It is tempting to look at a problem like—well, that uses terms like "deficit reduction contribution," and the "appropriate discount rate for current liabilities," and think that we're talking about dry facts and figures and numbers.

The reality is that we are dealing with real people. Last week, I was on a radio show with a steelworker from Weirton Steel, who had been told by both a union and his management that their pension plan was fully funded. A few days later, it went to the PBGC, and they discovered that it was about 35 percent funded.

The difference was not a lie, it was a matter of which measure you were using, whether you were using the current liability or the termination liability. And the—how this Congress resolves such seemingly very technical issues is going to affect the lives of very real people, some of whom have worked for 40 and 50 years in rather incredible conditions.

About 20 years ago, I was working with a Member from this side of the House on banking issues, and we started dealing—hearing about problems with the S&L industry. And we were told that the S&L industry was absolutely vital to our nation's housing markets, but that it had a few minor problems here and there, but just a couple of corrections—and most key, is that Congress had to forebear. Congress had to ease off on some of the funding requirements that the S&L's had, and all would be well.

Well, Congress passed legislation that did that, and it discovered very shortly thereafter that precisely the opposite was true, that if they had taken some very stern steps—which would have been politically uncomfortable—early, they would have saved the taxpayers a few hundred billion dollars.

I am not suggesting that there is an exact parallel between what's going on with defined benefit plans and the S&L industry. However, if Congress and this Committee do not want to sit here in a few years doing a bail-out of the PBGC with multi-hundreds of billions of dollars, the fastest thing that it can do is to avoid making any forbearance or any changes in the deficit reduction contribution.

Telling companies that are already ill, that are already underfunded, regardless of what industry they are in, that they have another 3 years or whatever to make up their balances—the underfunding in their pension plan—is a sure recipe for disaster.

The simple fact is that PBGC, like the FDIC and the FSLIC of late lamented memory, is a market distortion. It's a form of an insurance that may be incredibly important, and have great value, but it has very complex funding rules that allow companies, sometimes for the best of reasons, to game the system.

In the S&L industry, they used something called regulatory goodwill, regulatory capital, and ended up paying the price. Playing around with the wrong funding rules for pensions can have the same result.

In my testimony, I mentioned why I so strongly support the Administration's position on coming up with an appropriate discount rate, including the use of a yield curve that looks at the age of the relative workforce being covered by the pension plan.

Let me suggest, once again, that this affects real workers, and the decisions that are made here also affect the taxpayers. There are an awful lot of taxpayers who ended up funding S&L failures, and the like, who didn't necessarily have to.

Another matter of key concern is the termination liability. I talked to this steel worker, and he said, essentially, "Listen. I was told all was well," and that was because they were using the discount rate.

The fact was that the termination liability—and this is especially true in the case of Bethlehem Steel, U.S. Airways, and that sort of thing—proved to be a much more important guide to both the taxpayer, in the form of the PBGC, and the worker, in the form of the retirees, than did the present liability method, the current liability method.

If Congress is going to take action, a short-term action—and I applaud you for doing so—to make the 2-year change, as with the legislation that's passed here this year, it also needs to take short-term action to improve the information that workers get about their pension plans. A person should not wake up and turn on the radio and discover that his pension had declined from roughly $2,500 a month to $1,500, a month, 2 months after he had retired.

Similarly—and here we have, in the form of gaming the system—it is absolutely essential that Congress take quick action to make sure that a company which is facing severe financial pressures doesn't go to its work force and say, "Gee, rather than giving you a 3 percent pay raise this week, we will increase your pension benefits by 5 percent in future years," only to find that the taxpayers, essentially, are going to be on the hook for that. Those two measures should be enacted as quickly as possible.

The United Kingdom is going through a similar problem with its form of defined pension plan. It's called a final salary thing. And they're discovering precisely how expensive this type of reform is. The added costs may put the remainder of their final salary plans under. Early action by this Congress can make sure that that doesn't happen here. Thank you.

[The prepared statement of Mr. John follows:]

Statement of David C. John, Research Fellow, Thomas A. Roe Institute for Economic Policy Studies, The Heritage Foundation, Washington, DC

I appreciate the opportunity to appear before you today to discuss the an appropriate funding rule for America's defined benefit pension plans. This is an extremely important subject, and I would like to thank Chairman Boehner for scheduling this hearing. Let me begin by noting that while I am a Research Fellow in Social Security and Financial Institutions at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

What a difference a year makes. Last year, there was a great deal of discussion about the "dangers" of 401k retirement plans and other types of defined contribution plans. Experts warned, with some justification that retirement plans where workers had to invest their money faced investment risks. Many of those same experts and legislators called for a return of the good old days when employees were part of a defined benefit retirement plan. Under those plans, rather than having a retirement benefit based on one's investments, a worker receives a company paid benefit based on his or her length of employment and salary history. In theory, defined benefit plans are paid from a separate fund managed by the company or by financial professionals chosen by them.

Those experts implied that these defined benefit plans had little or no risk. They were wrong. Since then, a number of companies have dropped their defined benefit pension plans as part of a bankruptcy proceeding. Most recently, Weirton Steel became the latest company to try to dump their pension obligations on the taxpayer. Last week, I was a guest on a radio show that originates in the Ohio Valley area, and had the opportunity to speak to several steel workers whose pensions were going to be affected by Weirton's actions. Their stories were a forceful reminder that this is not just a policy issue, it affects real people's lives in the most direct way at the time when they are likely to be least able to change their circumstances.

Now Congress is debating legislation that would allow companies just a little more time to fund their pension plans. It is also looking a ways to change the regulatory framework so that under funded pension plans look like they have just a bit more in assets. Companies claim that without this help, jobs will be lost and the economy will suffer.

The S&L Crisis: Are We On the Same Track With Pensions?

Earlier this month, I testified at a Senate Special Committee on Aging hearing entitled "Americas Pensions: The Next S&L Crisis." That title could not be more to the point. It also brings back some painful memories. Back in the early 1980's, I worked as Legislative Director to a member of the House Banking Committee, former Rep. Doug Barnard of Georgia, as Congress considered legislation dealing with the early signs of the S&L crisis.

At the time, we were told that the industry was essential to America's economy, and that even though they were beginning to run deficits, all that was needed was a little forbearance. As a result, Congress created a regulatory form of capital called "good will" which allowed S&Ls to count an estimate of their reputations and business relationships as part of capital. At first, the gimmick worked like a wonder. S&Ls suddenly had not only enough capital to be "healthy" but to expand.

Of course, the net result was that when the industry finally collapsed the expanded S&Ls had lost even more money than they would have if they had been allowed to face economic reality several years earlier. The cost to America's taxpayers was somewhere around $500 billion. By showing forbearance, Congress had really just made the problem worse and increased the eventual cost. That example could also apply to America's pensions.

The S&L crisis has a direct parallel to what we are discussing today. The Senate Finance Committee has approved legislation that includes a three year holiday on the Deficit Reduction Contribution, a mechanism created in 1987 to require companies with chronically underfunded pension plans to increase the assets in those plans. Such a move, regardless of the problems faced by a few industries, would practically guarantee that we will be sitting here in a few years discussing a multihundred billion dollar bailout of the PBGC. It would be extremely irresponsible, and I would hope that the Administration would veto any bill containing such a funding holiday.

Currently, 12 percent of the labor force is covered by defined benefit pension plans, while an additional 7 percent is covered by both defined benefit and defined contribution plans. Under a defined benefit plan, a worker is promised a retirement benefit based on a percentage of salary for each year worked or similar measures. While the worker does not have the direct investment risk associated with a 401(k) plan, the benefits depend on whether or not the plan is fully funded. The risk that it is not fully funded can be as great or greater than the risk from stock and bond investments, but it is usually much harder for the worker to determine how high that risk is.

A Proper Discount Rate for Defined Benefit Pension Plans.

A key question is whether the pension plan's level of funding is being measured properly. A July 8 proposal by the U.S. Department of the Treasury addresses both the proper way to measure pension plan funding and ways to make it easier for workers and others to determine whether their company's pension plan is at risk. It also proposes ways to prevent companies that are in financial trouble from making promises to their workers and then making the taxpayers pay for them.

The Treasury Department's plan is far superior to the discount rate provisions in the July 18 version of the Portman–Cardin bill passed by the House Ways and Means Committee—H.R.1776, named for the bill's two principal sponsors, Representatives Rob Portman (R–OH) and Benjamin L. Cardin (D–MD)—and Congress should consider incorporating Treasury's proposed reforms into the final bill. As a short term alternative—with the full understanding that this is a temporary measure, Congress should consider a two year shift to a corporate bond rate, such as that contained in HR 3108.

Why an Appropriate Discount Rate Is Important

The funding of a defined benefit pension plan is measured using a "discount rate." A plan is assumed to be fully funded if the assets that it currently has can be expected to grow at a certain interest rate until the resulting level of assets then equals the total amount of pension payments that the plan promises to make in the future. For example, if a fund will owe $1,000 in 30 years and assumes that its assets will earn an average of 5 percent every year after inflation, it must have $231 today in order to be fully funded. (Invested at a 5 percent interest rate, $231 will grow to $1,000 in 30 years.)

The discount (interest) rate used to measure a plan's funding is crucial. If a plan assumes that its assets will grow at 7 percent a year instead of 5 percent, it needs only $131 today to be fully funded (rather than the $231 it would need if it used a 5 percent rate). On the other hand, if a plan uses a discount rate of only 3 percent, then it must have $412 on hand today to be fully funded.

The discount rate has no actual relationship to how much a pension plan's investments are earning. While the law requires that plans make prudent investments, these investments can change over time and are greatly affected by short-term swings in the stock, bond, and property markets. The discount rate is intended to measure whether or not the plan has sufficient assets to meet its obligations over a long period of time; thus, a defined benefit plan uses the rate for long-term government or corporate bonds instead of the rate of interest the plan is earning on its investments.

Over the years, Congress has tinkered with the appropriate discount rate in order to address specific problems as they arose. From 1987 to 2002, the law required that defined benefit pension plans use a weighted four-year average of the returns of the 30-year U.S. Treasury bond rate as their discount rate for determining funding adequacy. Under the 1987 law, plans were allowed to use any number between 90 percent and 110 percent of that rate. The spread between 90 percent and 110 percent was intended to allow the pension plan a slight amount of flexibility in its calculations. In 1994, Congress narrowed this range to between 90 percent and 105 percent of that weighted average. This discount rate is also used to determine lump-sum benefits for workers who want a one-time payment instead of a monthly check.

However, using this rate presents two problems. First, the Treasury Department announced in 2001 that it would stop issuing the 30-year Treasury bond. As a result, market prices for these bonds are distorted by the realization that they will no longer be issued. Second, interest rates in general are at a historic low, reaching levels not seen for almost 50 years. While economists expect them to rise gradually, pension plans argue that using today's low rate would make pension plans look far more underfunded than they actually are. Continued use of today's rate would force companies to assign pension plans literally billions of dollars that could be used more effectively to build the company.

Recognizing that the old discount rate was too low, in 2002, Congress allowed pension plans to use instead a number equal to 120 percent of the four-year average of the 30-year Treasury bond rate. However, this law expires after 2003. Some corporations have proposed that Congress substitute a longer-term corporate bond rate for the 30-year Treasury rate. Since corporate bonds do not have the full faith and credit of the United States behind them, they have higher interest rates. Using those higher interest rates would sharply reduce the amount of money that a pension plan must have on hand in order to avoid being underfunded while still protecting the funding status of the plan.

The changes in the discount rate between 1987 and now have had an effect. Each, along with other changes in the law including the establishment of a 90 percent minimum full funding rate in 1994, have addressed specific problems. In most cases, there has been at least a temporary improvement. For instance, the 1994 law saw a chronic underfunding of these pension plans (in the aggregate) change into a significant surplus. However, despite improvements after each change, these changes have proven to be temporary until the next change in circumstances requires yet another urgent debate.

Recent circumstances are forcing Congress to yet again examine the appropriate discount rate. As will be discussed below, the Treasury Department has made a proposal that would significantly improve the discount rate. However, simply looking at the discount rate for current liabilities may not be enough. For both the affected workers and for taxpayers as a whole, it may be even more important to look at the termination liability of chronically underfunded pension plans.

How the Treasury Department Proposal Would Affect the Discount Rate

On July 8, the Treasury Department proposed that a two-stage change in the pension plan discount rate be substituted for the current 30-year Treasury bond rate. For the next two years, the Treasury proposal would allow plans to use Congress's choice of either the 20-year or 30-year corporate bond rate. After that two-year period, companies would begin a three-year transition to using a corporate bond interest rate determined by the average age of an individual company's workforce.

Since companies with older workers will begin to pay out pension benefits sooner than companies with younger workers, the Treasury Department proposal would require companies with older workers to use a shorter-term corporate bond rate. Short-term bonds of all types have a lower annual interest rate than longer-term bonds do. This lower discount rate means that those companies would have to have proportionately more assets available to pay pension benefits. Companies with younger workers could use a longer corporate bond rate, which would allow them to have proportionately less cash and other assets available. This is an important reform that should be carefully considered.

The simple fact is that some industries and companies have workforces that are older on average than others. Since these companies will have to begin paying their workers' pension benefits sooner, the health of their pension plans is a significant factor in their ability to remain in business. If their pension plans are underfunded and the company has to make significant payments to them, that company is at a higher risk of bankruptcy than if the same company had a younger average workforce. Rather than using a uniform measure for all companies, it is much more prudent to use a discount rate that is customized to reflect a particular company's workers.

Using a customized discount rate as proposed by the Treasury Department would allow workers and investors to better understand a company's overall financial health. The customized discount rate also should allow earlier identification of problem companies so that changes can be required before they become critical.

Balancing the Interests of Workers, Companies, and Taxpayers

It is tempting to see the issue of discount rates as affecting only the amount that cash-strapped companies will have to divert to their pension plans. However, much more is at stake. Changing the discount rate to just a single long-term corporate rate might benefit companies by lowering the amount that they have to contribute to pension plans, but it also might hurt both workers and taxpayers in the long run. Workers who want to take a lump-sum pension distribution instead of monthly payments would receive less under such a system than they would under the current discount rate.

Lump-sum pension benefits are calculated by determining the total amount of pension benefits owed over a lifetime and calculating how much money invested today at the discount rate is needed to grow into the promised total amount. The higher the discount rate, the lower the amount of money that will be necessary to grow into that promised benefit, and the lower the lump sum benefit. At the same time, too low a discount rate may mean a lump-sum payment that is too high, thus further draining the plan of needed assets.

In determining an appropriate discount rate, Congress must balance the needs of both pension plans and retirees wishing to take a lump sum benefit. Similarly, if Congress only substitutes a higher uniform discount rate for the present one, taxpayers could find themselves required to pay higher taxes to make up for Pension Benefit Guarantee Corporation (PBGC) deficits. The PBGC is the federal insurance agency that takes over insolvent pension plans and pays benefits to retirees. Even though the PBGC limits the amount that it pays to each retiree, taxpayers can expect Congress to bail out the agency with additional tax money if the agency runs major deficits.

When Congress considers the appropriate discount rate, it must take into consideration the risk that an overly generous discount rate will result in more underfunded pension plans, and thus that more of those plans will be turned over to the PBGC for payment. This is especially true if legislation contains a holiday on the Deficit Reduction Contribution. This is not just an issue that concerns companies; taxpayers have an equal stake in its outcome.

Termination Liability

As important as the debate over the appropriate discount rate is, its use is not sufficient to protect either workers or taxpayers. As the PBGC has pointed out, many chronically underfunded plans look reasonably healthy until they are terminated. For instance, Bethlehem Steel's pension plan reported that it was 84 percent funded under current liability rules, but proved to be only 45 percent funded when the plan terminated. The US Airways pilots' plan reported that it was 94 percent funded, but proved to be less than 35 percent funded when it was terminated. Most recently, Weirton Steel's pension plan was only about 39 percent funded when it terminated. I spoke to one worker with over 20 years service who was told by both management and his union head that the pension plan was funded. They were not lying, they were just using another measure—one that proved to be meaningless when the plan went under PBGC control.

The simple fact is that while there is some value to measuring current liabilities, it is not sufficient. Pension accounting is a regulatory game that must come closer to reality. It is meaningless to the Weirton Steel worker if his plan looks relatively healthy before it is terminated. What is important is finding out that his pension will be reduced. Similarly, as a taxpayer, I could care less if Bethlehem Steel's plan met minimum funding requirement for most of the years prior to its end. What does interest me is the $4.3 billion shortfall that I or my children may have to help cover.

PBGC is a Market Distortion

PBGC, despite having an important mission, is a creation of government and would not exist in the marketplace in its current form. Just like the FDIC and the old Federal Savings and Loan Insurance Corporation, its protection is not free. Because PBGC is a distortion in the market, its politically set insurance premiums and regulatory guidelines are open to gaming by corporations and others who want to pass part of the cost of their pension plans to the taxpayer. The current debate over an appropriate discount rate is another example of this.

This is not to say that the agency does not serve a valuable purpose, but to recognize that its presence increases the risk that taxpayers will end up paying for the protection it offers. Until PBGC is either reformed to include a premium rate that includes a more effective measure of risk or changed into an agency that helps to arrange properly priced private sector insurance, debates about pension funding status are going to reoccur on a regular basis.

Two Other Important Reforms

The Treasury Department proposal includes two additional reforms that would increase the information available to workers and investors and lower the potential liability to the PBGC. Even if agreement on the discount rate cannot be reached for now, Congress should swiftly consider making the following reforms:

1.Improved Information

All too often, the true status of a defined benefit pension plan is unknown to the affected companies' workers and investors. The Treasury Department proposal would require pension plans that are underfunded by more than $50 million to make a more timely and accurate disclosure of their assets, liabilities, and funding ratios. In addition, while phasing in the new discount rate changes, all plans would have to make an annual disclosure of their pension liabilities using the duration matched yield curve. This reform would further improve the ability of workers and investors to judge whether a pension plan is properly funded.

Finally, pension plans would have to disclose whether they have enough assets available to pay the full amount of benefits that workers have already earned. As mentioned above, requiring disclosure of "termination basis" would ensure that if the company files for bankruptcy and seeks to terminate its pension plan, workers are not suddenly surprised to find that the plan cannot pay the pension benefits they have already earned.

2.Reduced Taxpayer Liability

Companies that are in severe financial trouble often try to keep their workers happy by promising them higher pension benefits. Similarly, companies in bankruptcy sometimes seek to improve pension benefits in return for salary concessions. In both cases, these higher pension promises often get passed on to the PBGC, and thus to the taxpayers, for payment when the company seeks to terminate its pension plan. The proposed reforms would prevent severely underfunded pension plans from promising higher pension benefits or allowing lump-sum payments unless the company fully pays for those improvements by making additional contributions to its pension plan. Similar restrictions would apply to companies that file for bankruptcy.

How Not to Improve the Situation.

The one thing that Congress should not do is to repeat the sad experience of the 1980's. Unless there is hard evidence that a company will recover its economic health, Congress should not casually extend the amount of time that corporations have to fund their pension plans. While this may be justified on a case-by-case basis, a general rule is likely to just mean that taxpayers will have to pay more to bail out the PBGC when it runs out of money.

And that day is inevitable unless Congress takes a serious look at PBGC and the entire retirement situation. This is not a problem where individual mini-crises should be considered to be unrelated. PBGC has an investment portfolio that includes a sizeable proportion of government bonds. It is true that unlike Social Security, which simply stores the special issue treasury bonds in its trust fund, PBGC builds its portfolio by trading its special issue bonds with the Bureau of the Public Debt. However, that portfolio growth gives a false sense of assurance.

When the time comes for PBGC to liquidate its portfolio to pay benefits, we may see the "perfect storm" where both Social Security and Medicare are liquidating their government bond portfolio at the same time. Even though PBGC is the smallest of these agencies by a large margin, the only way that it will be able to raise the money that it needs for benefit payments is to either sell its bond portfolio on the open market or to return them for repayment. Neither option looks promising at this point. If the government is borrowing massive amounts of money, the prices of bonds can be expected to be unstable at best. And if Social Security and Medicare are consuming massive amounts of government resources, PBGC can expect a place behind them.

Thoughts for the Future.

As an alternative, Congress should consider a close examination of the entire retirement situation ranging from Social Security to private pension plans to incentives for people to work. Among steps that could be considered are:

1. Reform PBGC: PBGC has done a fine job with what it has, but the structure is fundamentally flawed. Premiums are inadequate, and are not based on any measure of the risk that the employer will turn its pension plan over to the agency. Investment strategies are less than adequate. Rather than a piecemeal review, Congress should begin now a thorough review of the agency .
2. Encourage Small Business to Form Retirement Pools: About 50 percent of the US workforce has no private pension plan. Many of these workers are employed by smaller businesses that cannot afford to sponsor any sort of retirement plan. Current legislative efforts to remedy this situation have centered on reducing the regulatory burden that is a major part of the cost of having a pension plan. Instead, Congress should consider an alternate approach. Rather than expecting every small business to have its own retirement plan, encourage them to form pools, perhaps based around associations, chambers of commerce, or other affinity group. This would work best with defined contribution retirement plans.
3. Phase Out Defined Benefit Plans: Sadly, it may be time to recognize that in the future workers will have more job mobility than they even do now, and that a defined benefit plan may not be in their best interests. Congress should consider developing incentives for companies to shift their retirement plans to defined contribution plans.
4. Encourage Workers to Work Longer: In the future, there will be fewer younger people to take the jobs of those who retire, and a resulting demand for older workers who are willing to stay in the workforce—even if it is only on a part-time basis. Congress should examine the various workplace rules now to remove regulatory and other obstacles
5. Reform Social Security: Every day that Congress and the Administration delays reforming Social Security, there is one less day that the program will have surpluses. The Social Security trustees warn that the program will begin to run cash flow deficits within 15 years. There is a pool of IOUs known as the trust fund, which can be used to help pay benefits until they run out in 2042, but in order to liquidate them, Congress will have to come up with about $5 trillion (in today's dollars) from general revenue. The last thing that future retirees need is to find out that both their company pension plan and Social Security are unable to pay all of their promised benefits.

Thank you for the opportunity to testify. I look forward to your questions.

Chairman BOEHNER. Thank you, Mr. John, and let me thank all the witnesses for their excellent testimony.

And let me make it clear for our witnesses, our guests, and our Members, it's the intent of this Committee to take a very comprehensive look at what needs to be done to strengthen defined benefit pension plans, and to try to find that perfect balance between making sure that they're properly funded, and that we don't unintentionally drive the employers and others out of the system, as you have all pointed out.

Let me ask the big question. In Mr. Krinsky's testimony, he says on page 18, "Today, the PBGC has total assets in excess of $25 billion, and it earns money from these investments on those assets. And while the PBGC reports liabilities of approximately $29 billion, the annuity pension obligations underlying those liabilities come due over many decades, during which time the PBGC can expect to experience investment gains to offset any paper deficit that exists today."

And it should be noted that these liability projections by the PBGC are based on unrealistic interest rates and mortality assumptions, and make the agency's liabilities appear larger than they actually are.

So the first question is, how serious is the crisis that we're facing, or is it serious? And Mr. Krinsky, I would let you expound upon your written testimony.

Mr. KRINSKY. I will expound only very briefly and add to that only briefly. I think there is a difference between the S&L crisis and the PBGC crisis, in that PBGC's obligation is to pay benefits over decades to people who—this S&L crisis was such that people had immediate claim on their bank accounts.

And therefore, even if I—I mean, I subscribe to what I said there—but even if I am wrong to a certain extent—and there have to be some further adjustments made—they can be made over time, a luxury you never had in the savings and loan crisis.

Chairman BOEHNER. Well, just to expound upon what you said, I mean, we have all heard the term, "the perfect storm." Historically low interest rates, a stock market that has been off, and an increasing number of retirements. I mean, is the picture that's being painted worse than reality? I would ask Mr. Iwry to comment.

Mr. IWRY. Mr. Chairman, I think, first, what we need from the PBGC is a completely forthcoming sharing of the assumptions and the data, apropos of your comment about Mr. Krinsky's point.

We shouldn't have to speculate, and we shouldn't have to debate with PBGC as to what the facts are regarding the exposure. Obviously, there are elements of judgment there, as to whether particular plans are likely to terminate at some point in the future.

But we should be able to make those judgment calls with the facts laid out in front of us, and the assumptions—

Chairman BOEHNER. Yes, but you spent 10 years down at Treasury, you have dealt with these issues. You have got some opinion about whether we're having a crisis or whether we're not having a crisis.

Mr. IWRY. I do. And I think that the situation is, you know, is most constructively addressed in terms of what do we do about it. I mean, it's a problem. There is no question that there is a serious underfunding problem. I think—

Chairman BOEHNER. Well, let me rephrase it.

Mr. IWRY. Yes.

Chairman BOEHNER. Let us assume that interest rates rise. They really cannot go any lower; they have got nowhere to go but up. Let us assume that the stock market continues to rebound. If those two things were to occur, do we really have a problem? Do we have a crisis or do we have a problem? That is what I am trying to—

Mr. IWRY. I would say that we have a problem, and that is it heterogeneous. In some industries, obviously, we have got tremendous secular issues. We have got liabilities that were completely unanticipated, relative to the capitalization of the company—unanticipated at the time that Mr. Gordon and others were working on ERISA.

We have, in most of our plan sponsor universe, though, a situation that is not dire. And I think we need to recognize that it is—we have got a bimodal issue here. We have got one area that is in terrible trouble—certain old-line manufacturing industries were well aware of that—and we have got most industries that are, in effect, having to subsidize the plan benefits in the troubled industries.

And I think we have just got to deal with it. We have got to change the rules. It is clear that things like the funding holidays that troubled companies have enjoyed, the fact that they haven't had to make accelerated funding contributions over the past few years until just before the company went under, and the plan was dumped on the PBGC, those things need to be addressed.

Chairman BOEHNER. The rules—I am about to run myself out of time, and I want to get to one other issue—the funding rules that were changed in 1994 put these deficit reduction contributions into place. And they have really never—they have never really been tested until now.

Do we have anyone on the panel who would have an opinion as to whether these rules make sense, or whether it would be better described as heart surgery with a meat cleaver? Mr. Krinsky?

Mr. KRINSKY. The purpose is good. In practice, the volatility is terrible. And I think that there are just a number of companies who have funded their pension plans who, by the technical nature of this, and the intersecting and overlapping liabilities. I mean, I brought a pension report along with me on the plane this morning, and I counted four different numbers labeled "liabilities" in our report.

It is very complicated. There are seven different kinds of contributions that are annual costs by various measures. The whole thing needs some simplifying, so people can understand what they're doing.

Ironically, I mean, the best-funded plans that I deal with are non-profit organizations without any unrelated business income tax, who make large contributions mainly to avoid paying the second level of PBGC premium, because they can do it without getting penalized by the IRS, and they fund their plans very well, and they don't have to, in effect, waste money on the PBGC premiums.

Chairman BOEHNER. Mr. Gordon?

Mr. GORDON. In our testimony, we point out the difference between theory and practice on the deficit reduction rules. I think, in theory, even in theory, there is kind of a disconnect between the funding rules that were originally adopted as part of ERISA, and these—which you amortize liabilities over a long period of time, sort of like paying off a mortgage on a house—and the deficit reduction rules which take a photograph of your status, what was referred to earlier as determination, liability over a particular moment of time, as if that was a decisive moment in time, for purposes of dealing with a funding situation.

Now, the reason that was done had a lot to do with concerns over a looming S&L-type crisis overtaking PBGC, and the fact that PBGC was, in the single-employer fund, seriously in the red, and so on and so forth.

But I think that while you can still make a pretty good case for having this photograph in time serve as a way to boost funding and protect PBGC, it becomes more difficult to make that case, or more of a—it creates more practical problems when you have a contracting universe of defined benefit plans.

The more contracts, the more this—these deficit rules have a tendency to make it contract more, because employers are not going to want to continue to establish or maintain defined benefit plans if they are faced with this—what you call—a meat cleaver.

So, I think we have to find some type of new configuration for dealing with these rules in the context of a declining defined benefit plan universe. That is the new kid on the block, that is really what we have to pay attention to, and this process was going on and is still going on, regardless of what happens in particular industries, because as Representative Andrews said, it is part of structural changes in the nation's economy.

Chairman BOEHNER. Mr. Iwry?

Mr. IWRY. Mr. Chairman, in response to your question, I think that without this deficit reduction contribution introduced in 1987 and bolstered in 1984, we would be even worse off today, in terms of underfunding, than we are now.

It isn't working well. It needs to be fixed so that it is less volatile, as Mr. Krinsky and others have said. But the fundamental technique simply comes down to asking underfunded plans to pull their socks up and get better funded. And as you said, it's a matter of balancing.

How quickly do people need to get the funding in there, in order to return to a prudent funded status? And that's the kind of fine tuning that I think needs to be done in this next round.

Chairman BOEHNER. Well, I could—if Mr. Andrews will excuse me—before I introduce him, let me make it clear to all of you that having looked at what has gone on the last 20 years of fine-tuning, what we have created is a very complex, very difficult system of rules and regulations, to a point where you wonder why anybody in the private sector would voluntarily want to offer such a plan and deal with the complexity of it.

I suggest—those are my words, not yours—but I can assure you that, as this Committee moves forward, we are going to go well beyond fine-tuning. I think it is time for a serious review of all the rules and all the regulations around defined benefit plans, to take a full review and a more comprehensive look at the changes that need to occur, if, in fact, we are going to keep these plans in existence, and also meet the obligation of having them properly funded to meet the retirement security needs of their employees. Mr. Andrews?

Mr. ANDREWS. Thank you, Mr. Chairman. I appreciate the statements from each of the witnesses.

I think the Chairman's comments suggest and the witnesses suggest that we should conduct this comprehensive review by understanding three disparate circumstances that defined benefit plans and their sponsors find themselves in.

The first circumstance is economic distress, like the steel industry, where, because the revenue base of the industry is eroding, and the number of workers is dropping precipitously, that the industry is in grave economic trouble and more likely to fail, and more likely to be a significant drain on PBGC resources.

The second circumstance would be normal economic circumstances, some profitable companies, some unprofitable companies, confronting what the Chairman talked about as the perfect storm—that is, external factors dealing with pension investments and pension circumstances that are within the realm of normal economic problems.

And then the third situation in which people find themselves is the profitable firm, profitable company, that finds itself cash flush, and may wish to build on its success by advance funding some of its pension obligation.

So I want to start with that happy circumstance of the third firm, of which we have precious few in this economy, but I wanted to ask Mr. Krinsky if he would favor a lifting of the ceiling that such a company could make as a contribution to its defined benefit plan.

Should we permit companies to make unlimited contributions to their DB plans voluntarily, without the excise tax?

Mr. KRINSKY. Unlimited, probably not. My guess, that there is something between what exists now and unlimited, having to do with years of prior contributions and various—I think it requires a comprehensive review.

Mr. ANDREWS. Where do you think that point is?

Mr. KRINSKY. I don't think—I don't have that point in—

Mr. ANDREWS. Do you think it would be a viable strategy to sort of make a swap, to say to these more strong companies that, in exchange for being able to shelter more of their profit by making a contribution, that they pay a stepped up PBGC contribution that is—but they still come out far ahead.

In other words, the tax savings would dwarf the increased PBGC contributions, the way of getting more revenue into PBGC.

Mr. KRINSKY. I find it difficult at this point to come up with a specific proposal. I think it is important in the long run—and to take a long-run picture—to see that the defined benefit system will still be there.

We have a famous three-legged stool of personal savings—which, in this economy, is not doing it—and my own favorite thing here is that states are taking away lottery money from those who can't afford it, but that's another subject entirely.

Second is the public's—the private sector, which is doing defined contribution plans and defined benefit plans. In this perfect storm, the defined contribution plans, while very attractive as supplements, have not done it.

And then defined benefit plans are not doing it. The result of that, long term, the baby boom, is your view when you go home, I suspect—with great respect—will find the Baby Boomers, as they age, pressuring for much more Social Security benefits, which is something—

Mr. ANDREWS. I'm sure that's going to—let me ask Mr. Gordon. In your testimony, you indicated that you are looking at the importance of—no one understands how plans that were swimming in huge pension surpluses just a few years ago suddenly became so monumentally underfunded.

Would you favor a law that would require employee representation on boards of pension funds so that they may have a front row seat?

Mr. GORDON. I'm conflicted about that, and the reason I'm conflicted about it is because that may require them to become fiduciaries. If they become fiduciaries, that means that they have to get bonding and fiduciary insurance. Who is going to pay for that?

Probably going to have to be paid for by the employer, which means that their independence of judgment may be—

Mr. ANDREWS. Maybe some Sarbanes-Oxley problems here, too.

Mr. GORDON. Right. And that, by the way, I would like to tie that to your previous question about perhaps lifting the ceiling on funding. I think that that issue is also intimately connected with corporate governance problems, and relates to the questions that retirees and workers have about what happened to the surpluses.

The fact of the matter is that these surpluses were used to artificially boost the financial statements of the companies.

Mr. ANDREWS. Yes.

Mr. GORDON. And to justify increases in executive compensation when, on the basis of pure economic performance by those companies, those increases in executive compensation would not have been justified.

Mr. ANDREWS. A mechanism to make sure there were actual surpluses that would—

Mr. GORDON. Well, not only that there were actual surpluses, but that they were not the sole—that the company does not anymore have sole ownership, sole dibs on those surpluses, that they belong to the plan, and they ultimately belong to the participants and beneficiaries beyond a certain point that is needed for funding.

Mr. ANDREWS. Thank you. I wonder if I could just conclude quickly with a question for Mr. John on—in your testimony, you tell us one thing we should not do is repeat the sad experience of the 1980's, with respect to the S&L problem.

You say, "Unless there is hard evidence that a company will recover its economic health, Congress should not casually extend the amount of time that corporations have to fund their pension plans." That would suggest an earlier intervention—

Mr. JOHN. Yes.

Mr. ANDREWS [continuing]. For companies that are weak. How much earlier, and what tools should PBGC be given it does not have now to step in and stop the bleeding?

Mr. JOHN. Significantly earlier. And perhaps one of the easiest ways to do this would be to limit the ability of pension plans that are starting to show serious underfunding.

The law currently has a $50 million level. I would suggest that maybe that should be rephrased, in terms of a percentage basis, percentage underfunding. And I would use a percentage underfunding on a determination basis, because when it comes right down to it, if the plan is going to go into PBGC, that's what is important, not its current liability status.

Mr. ANDREWS. Thank you very much. Mr. Chairman, thank you.

Mr. BALLENGER [presiding]. I guess maybe it is my turn, since the Chairman has not come back.

I would like to ask a question, because I live in an area where a whole bunch of textile mills have gone bankrupt, and Pillowtex being the one that I would like to ask anybody that has got an answer to the question.

Substantial amounts of money are being paid for assets at various and sundry levels of buildings and inventories, and all this other stuff that belonged to—I guess the assets belonged to the company, even though it's bankrupt—but somebody, after the bankruptcy is declared, somebody is paying a whole bunch of money back to somebody, and does any of that money ever go to the pension that these people, the pension liabilities that could be funded, to some extent, with the assets that are being sold?

Am I asking—yes, Mr. John? Fire away.

Mr. JOHN. Well, the problem that you come into when you go into bankruptcy is that, assuming that the pension plan, as part of the bankruptcy, has gone to PBGC, PBGC then is a general creditor, along with the average stockholders, and things like that, which means they get a recovery after all the bondholders and various and sundry others. And usually the recover is in the nature of maybe 2 percent, or something like that. So it's not really very significant.

If—one of the things that you might want to look at is to address the level of PBGC's ability to intervene in a bankruptcy proceeding.

Mr. BALLENGER. Would we have to change a whole bunch of laws to do that? I am not a lawyer, so I do not really understand.

Mr. JOHN. I'm afraid, yes.

Mr. BALLENGER. Oh, God, that's great. I tell everybody once in a while that once upon a time I had a defined benefit plan, and then the Federal Government got involved, and so I dropped it and it became a defined contribution plan, and I think it was the smartest move I ever made in my life.

But is there anything in any of these plans where you project the additional life span that medicine has created? Especially Mr. Gordon, you would deal with this probably more than anybody else. We are all living longer, which means that the liabilities that everybody had planned on are never going to cover whatever you projected.

Mr. GORDON. Yes, that is true. The actuaries have let us down again. They were supposed to tell us when we were going to die; they got it wrong. Just like they got retiree health costs wrong, and everything else.

I quote the famous line from Machiavelli, "Put not your trust in actuaries."

Mr. BALLENGER. Mr. Krinsky?

Mr. KRINSKY. I don't know if Mr. Gordon knows it, or the Committee knows it, I am an actuary.

[Laughter.]

Mr. KRINSKY. And the actuarial assumption—to me, the serious answer to the question—the actuarial assumptions used to calculate liabilities have gradually changed over the—certainly there have been major differences in the tables that we are using now from those when I started working 49 years ago in the amount of the longevity that is predicted for pensioners. And they always tend to be on the conservative side.

So that, yes, that has been taken into account, it has been taken into account gradually. If there are quantum leaps because somebody finds a cure for cancer tomorrow, the full extent of that has not been taken into account.

Mr. BALLENGER. Right.

Mr. KRINSKY. But assuming that it continues to be a gradual progression, as our life expectancy statistics show, those things have been taken into account.

Mr. BALLENGER. I think the problem that goes with the elderly—and I happen to be one of them—is the fact that the longer we live, the more medicines we take, which eats into whatever income we might have because of the drugs, and the drugs become more and more expensive. So it's kind of an unending problem that I don't see any answers to. You cannot do this with statistics and stuff.

Mr. GORDON. One of the things that we could do is to create something like a more parallel ERISA regulatory regime for health plans than we have for pension plans, which means we could give better funding tax breaks to employers for funding those plans, have them invested more so they could take care of future health costs.

We don't have a system like that now. And the result is what we have seen, that the system is now disintegrating. A lot of employers, particularly large employers, can't wait to get out of it, or at least to reduce their costs as much as possible. And it usually ends up hurting a lot of very vulnerable people.

So, there are things that we could do about it, and then we could have a more integrated system between pensions and health.

Mr. BALLENGER. Thank you. I think Mr. Tierney?

Mr. TIERNEY. Thank you, Mr. Chairman. I want to thank the witnesses for their testimony.

Mr. Gordon, in your testimony you talked a little bit about earned pensions. Some people call them legacy costs, or whatever, but the earned pensions of people in some of the sicker industries, the steel and airlines. And I notice that you said it was a topic for another day in your testimony.

But to bring that day forward to now, can we do something about those costs and still, at the same time, maintain our current system, moving forward?

Mr. GORDON. Well, this is a very difficult problem, and I am going to try to crudely oversimplify it by saying it seems to me the choices between trying to take care of these problems in a better way through the PBGC funding regime, which means that we will end up ultimately shifting the burden, or spreading the burden, among the healthier industries and healthier employers and better funded plans, which may have the negative result of driving more and more of them out of the defined benefit plan universe, or we can stop what amounts to a back-door industrialization policy through PBGC, and go after it through the front door.

The front door would be providing some type of direct assistance. In my testimony, I specifically mention—I don't know about steel, but it certainly seems to me that there are certain industries that were having real problems that impact on national security.

I don't understand why we don't at least consider the possibility of providing them some form of direct assistance to help them with their pension funding problems if it does impact on national security. We don't want a bunch of demoralized workers dealing with problems of national security, or that impact on national security, and worried sick that they are never going to get their pensions, or that the pensions that they are going to get aren't going to be what they counted on.

So, I think that there are other ways of handling it, as far as that is concerned. And we have done—Congress has done that, in connection, for example, with the—even though it's controversial—the Coal Health Act, where they particularly did things to take care of the coal mine situation, and health plan situation there.

Mr. TIERNEY. Would you see some people arguing that, in essence, the taxpayer is bailing out the company on that, and that others might be encouraged, then, to let their work force get into that situation so that they, too, could have it shifted over to the tax burden?

Mr. GORDON. Well, it certainly is a difficult call, but we are no longer, it seems to me, whether we like it or not, in circumstances where—that we used to be IN, and where we have these kinds of free market models to play around with at our leisure.

We are now in an economy which is a partial war-time economy, and may even grow worse in that regard. And we have to take into account those considerations when we're dealing with particular industries.

If they are vital to what we are trying to accomplish, then we can't be constrained, it seems to me, by criteria that we would like to apply, but which really were applicable to an earlier period of time.

Mr. TIERNEY. Thank you. And just generally, anybody on the panel that wanted to answer opinions as to whether or not the defined pension benefit plan is something we want to continue to see on into the future, or are we looking at its decline to the point where it gets wiped out here. Sure.

Mr. KRINSKY. I think it is very important that they continue in the future, that we are—they are getting wiped out, to a certain extent, but as I said earlier, I think the result of wiping them out, particularly if we return to any sort of inflationary economy at any point, which some of us have lived through, whereby there is pressure to make up benefits for past years at low salaries, as there were when these plans started out, the change from career-average plans to final-average plans, you can't do that in a defined contribution plan.

So if a defined benefit plan is not there to do that, again, the pressure is on Social Security. That's the government support, and that becomes a major part of your political base, as well, an ever-growing part of your political base.

Ms. BOVBJERG. I would like to take that on a little bit. We have done a number of reports on Social Security and pensions, together, and I think the concern I have is, you know, I worry about PBGC and a shrinking group of plans.

At the same time, it's not as if we are seeing an increase in people who are covered by pensions. As a government, we have paid a lot of attention to improving coverage and participation, and we really haven't gotten very far. The number continues to be at about half of American workers who are participating in a pension plan at any given time.

And you look at retirees and sources of retirement income, it's about—it's actually a little less—than half of retirees who are getting income from pensions. So I worry less about the shift than about the aggregate, and what, really, we're providing people.

And we had done some work for Congressman Andrews on different generations saving at the same age, and what they might get in retirement. And where we came out at the end of that report was a lot of concern about what are we going to do about Social Security. Social Security is the thing that underlies most Americans'—the vast majority of Americans'—retirement income expectations.

We need, really, to do something about that very soon, that relative to PBGC really is a crisis that we need to address. But at the same time, though, we're thinking about a comprehensive solution to PBGC and pensions. We really need to think about how these things interact.

So, I guess I would like to second—I know a couple of others members of the panel have made some reference to that, and I would like to second that, as well.

Mr. TIERNEY. Thank you.

Mr. IWRY. Mr. Tierney, I think that whether defined benefit plans survive depends importantly on what the Congress does now with the defined benefit issues that are being focused on in this hearing, as well as the cash balance issue, and that it is not a lost cause, partly because the aging of the baby boomer generation gives a greater interest, potentially, in defined benefit plans to an important part of the population, or at least should provide that kind of interest.

What is particularly critical, I think, is to promote the continuation of employer-funded plans, be they defined benefit or defined contribution, not because the money is not ultimately coming out of the employee's wages and compensation—I think mostly it is—but because for most of the population that really needs the help in providing for retirement security—moderate income working people—it is easier to save if the employer helps, and if the employer provides some automatic form of saving. Defined benefit plans are great for that.

Profit-sharing plans, employer contributions to defined contribution plans, are also great for that, and a lot simpler than defined benefit plans. Each has its advantages, and I think we need to promote the aggregate of employer-funded retirement plans, as well as employee-funded plans, where that's all that we can encourage an employer to provide.

Chairman BOEHNER. The Chair recognizes the gentleman from Michigan, Mr. Ehlers.

Mr. EHLERS. Thank you, Mr. Chairman, and I would like to pursue some aspects of the question asked by Mr. Tierney, and the comments about outliers. And I hope this is not duplicative; I had to step out for a short time.

But let me take, particularly, the airline industry, and the problems they are facing now. And I have been told by some of them that if they have to meet the letter of the law in the current situation, it will drive them into Chapter 11, at a minimum.

And so, all the assurances that long-term this will all even out, and things will be OK when the stock market returns, interest rates go up, et cetera, doesn't help those industries, whether it's steel, airlines, or some others, or many of the small companies in my district that are on the verge of bankruptcy.

It is an immediate problem for them. And if it's not solved immediately in some fashion, or they don't get some assistance, they will go into bankruptcy. And I'm not sure that it helps anything, particularly if it's a permanent bankruptcy, it makes the problems for the Guaranty Corporation even worse.

I would appreciate some comments on that. Yes, Mr. Gordon?

Mr. GORDON. I think the problem is that we should not have to twist ERISA's funding and PBGC's rules into a pretzel in order to accommodate the airline industry. This doesn't mean that the situation should not be addressed. But I don't think that we should distort either the general funding principles or the deficit reduction principles, or any of those, to deal specifically with the airlines.

Now, I have, in my testimony, presented some type of funding waiver proposal with regard to deficit reduction rules which may be advantageous to the airlines, but they would have to take rather tough steps to curb the future growth of their plans. In effect, place themselves in a kind of quasi receivership status in order to get this relief.

Beyond that, it seems to me that it's unclear to me why, when Congress considered giving direct assistance to the airlines in connection with their insurance problems following 9/11, why, using that precedent, they can't also consider whether or not they could provide some form of direct assistance to help them with their funding problems.

Again, it seems this refers back to an earlier comment I made, that if you have an industry which impacts on national security, which I think the airlines do, then it seems to me that we ought to take measures above and beyond what otherwise we would do, under ERISA, to take care of those problems, if we can, and there is precedent for doing things like that.

Mr. EHLERS. Let me assure you, it is not just the airlines, and it is not just industries that are related to national security problems. It is much more widespread than that. And those of us in Congress hear this every weekend, when we go back home. So, yes, Mr. Krinsky.

Mr. KRINSKY. I was just going to really say what you just said. It is not just the airlines, and I think there needs to be some comprehensive approach taken to what the Chairman described as the perfect storm, which is the very low interest rates, the declining stock market, the particular timing of when actuarial valuations are done, and to look at whether some set of waivers, or some temporary relief can be given that will get us over this hump, assuming that the economy returns somewhat to what it had been in the past.

These are things that, with all due respect to my profession, the actuaries could not have predicted would all occur at once.

Mr. EHLERS. Ms. Bovbjerg?

Ms. BOVBJERG. Thank you. I wanted to express some of my reservations about whether a particular—some particular relief provided through a pension insurance program would really be what was fundamentally going to help these companies.

And I know that one of the things that we have seen at PBGC is that with some of these plans, PBGC gets them anyway, and then they are tremendously underfunded. And so, I guess the concern I would have about something like that is potentially starting with a much deeper hole at PBGC, and perhaps this is a broader economic question that we need to address outside of this insurance program that is very specific to a particular aspect of the company's obligations.

Mr. EHLERS. And let me just say that there will certainly be some instances of that. There will also be other instances of companies that will be able to make it, and therefore, will not be any drain at all on the PBGC.

Ms. BOVBJERG. Well, and I wanted to build on something that Mr. Gordon said, as well. In talking about some of these issues with David Walker, my boss, who used to be head of the PBGC and had other pension positions, and also serves on the airline of the board that was overseeing the aid to the airlines, and he had made the comment that he was very concerned about any kind of a broad-based relief, and was suggesting that perhaps you could do something like that that would be more targeted.

Now, this is something that, you know, we have discussed, I would say, rather casually. But that is—you know, there are other models, and we have been trying to think about that, perhaps not on the time table that you would like, and I appreciate that, but we are trying to think about those sorts of issues.

Mr. EHLERS. Yes, Mr. Iwry?

Mr. IWRY. I think that the points made are quite valid. There is reason for concern about a long-term distortion of the basic funding approach to help particular industry at a particular time, and that a more targeted approach than the one that the Senate Finance Committee has been taking thus far would be well worth considering, that when you go to conference with the Senate with a House bill that has relief with respect to the 30-year Treasury interest rate, but that does not have a 3-year waiver of the deficit reduction contribution that would apply, I believe, to most major companies in America, not just a particular industry or particularly troubled companies, and without any extensive conditions attached to it, I think that it would be good to question that in conference, and to ask whether some kind of improved funding waiver, some kind of more targeted, narrower, and more seriously conditioned procedure would be appropriate, so that Congress does not end up compromising its ability to make fundamental reforms in funding in the next phase starting next year, before next year even begins.

And I think the industry does deserve some consideration. There is some relief that is necessary. The question is, can it be crafted more narrowly to do less collateral damage to our whole system?

Mr. EHLERS. Well, I can assure you, with the Chairman we have on this Committee, we will come up with a superb product that will be much better than the Senate's. I yield back the balance of my time.

[Laughter.]

Chairman BOEHNER. The Chair recognizes the gentlelady from Georgia, Ms. Majette.

Ms. MAJETTE. Thank you, Mr. Chairman, and I thank the witnesses for being here today. I would like to hear some discussion about how you see that having more disclosure of the current funding status of a company's pension plan would really help to solve the underfunding crisis. Yes?

Ms. BOVBJERG. I brought that up, so I should probably take a shot at it. Really, I acknowledge that is not a solution, all by itself. But certainly, it would help. Participants do not know very accurately and very clearly what the funding status of their plan is. They don't know what benefits would be coming to them, if their plan went to—was taken over by PBGC.

They really have had great difficulty finding out—I think back to the U.S. Airways pilots, who were quite surprised to discover what their guaranteed benefits were going to be when PBGC took their program over.

We think it would help, we think that, for example, letting people know what the termination liability would be, since it can be so different from the current liability, would be a useful piece of information for actually more people than just participants, but certainly it would be helpful to participants. And we think that simply having these things out in the open does provide something of an incentive to better fund.

Ms. MAJETTE. Well, do you see that as causing—perhaps potentially causing shifts in investments that would be made in those companies if it looked like things weren't going as well as perhaps they would—investors would want to see them go, and that might, in turn, cause underfunding to continue if there is—if investment—if people decide to change their investments, it might sort of perpetuate a situation that is already not a good one?

Ms. BOVBJERG. And I do take your point, but I think that investors really deserve as much useful information as a company can provide. I think that would be helpful information to them, particularly if a plan is starting to have funding problems.

Termination liability can sometimes be quite different, because it includes early retirement that would not ordinarily occur when the company is a completely going concern, or they don't offer shutdown benefits.

I think with one of the companies we looked at—it was Anchor Glass, I believe—they were using age 64 as their normal retirement age for current liability. But when they calculated termination liability, it was age 58. It makes a big difference in cost.

And if I were an investor, I would want to know those things. I might not always know what to do with that information, but I would want to know it.

Ms. MAJETTE. Mr. Krinsky, did you want to weigh in on this?

Mr. KRINSKY. I think you said it in your last sentence. Participants—this stuff is so complicated. I mean, I do lots of one-on-one things, I pride myself on being able to teach pretty well in this area.

But the definitions of the various kinds of liabilities are so complicated. And if you have a good, healthy company, and you have a liability in your accounting statement, and the notes to your accounting statement, and there are other things available, and if you have to publish your termination liability and it's a great, big number, it's going to be—your point is well taken.

There are some people who will be scared by it. Whether it will do a lot of damage or not, I don't know. It is expensive to calculate and publish each one of these things, and to explain one of these things. You have to get people to do it. It's a balance, as to how much you give.

And I can guarantee you that I don't think it would make very much difference in the behavior in most participants in most plans—only the most sophisticated participants would really understand these subtle differences.

Ms. MAJETTE. And I guess my other concern with regard to that would be that—to make sure that people are able to compare apples to apples and oranges to oranges.

And I suspect that, even though you are setting out guidelines or parameters for this information to be calculated and then disseminated, it wouldn't necessarily be done in a way that people could make the kinds of comparisons to say, well, this is equal to this, or this is the same situation in one company or industry versus another company or industry.

And so I would want to see, if we are going to have that kind of disclosure, that everybody is on a level playing field, and everybody is required to produce it in the same way and use the same basic information to make those calculations.

And I guess, you know, age 59 retirement for one industry and 64 for another, that may not be the same, given the nature of the industry. If you say that air traffic controllers would retire earlier if they start earlier, because that is the nature of that work, versus another industry that people may work much longer because of the nature of that work.

And I think that is just a concern that I have about that whole issue, whether it is going to be even-handed.

Ms. BOVBJERG. And whether—and I can understand whether you ask everyone to do this, or some subset of industries, maybe depending on their plan funding status, or something like that.

Ms. MAJETTE. Yes.

Ms. BOVBJERG. Yes, I can understand your concern about that.

Ms. MAJETTE. And also, with respect to Mr. Gordon's comment about the vital industries, and how that vitality would shift over time, depending on if we are in a war-time economy or a quasi-war-time economy, or a non-war-time economy, and how all that would play out, in terms of making those people—having people be able to have information to make those long-term evaluations and how they should proceed.

Ms. BOVBJERG. I don't know—

Mr. JOHN. May I also respond, Ms. Majette? I think that it's very hard to make a case here that we should not have some improved disclosure. It can be done in a manner that is uniform, according to uniform rules, even though, in fact, the differences between industries and between particular plans are important differences, and those ought to be reflected in the assessment of the risk facing that particular plan and the employees in it.

I think Mr. Krinsky makes a valid point in noting that there are situations where a company is perfectly strong, financially, and there, what's at stake, in terms of the actual percentage funding in that plan is a lot less than what's at stake with a weak company.

If a company is strong, and stays so for the long term, it can validly fund, in a gradual way, over time. I think, therefore, that there is a reasonable middle ground here whereby companies that are in circumstances where it becomes more relevant to know what termination liability is would have to disclose on that basis. At least that set of companies.

And I think that is why Mr. Miller has proposed a greater disclosure along these lines with various co-sponsors, and why the Administration has proposed this kind of termination liability disclosure, whether it's limited to a more targeted group or not.

Ms. MAJETTE. I agree that there should be more disclosure, but not to the extent that it is unduly burdensome on those who are required to make their disclosure.

Mr. GORDON. Ms. Majette, if I may just weigh in briefly, there may be responsibilities now for disclosure under ERISA, under the fiduciary principles. Courts have held that if there are circumstances that—regarding the operation or the benefit plan that would be adverse to the participants, or turn out to be adverse to the participants, that a fiduciary has an affirmative obligation to disclose those circumstances to the participants.

So, you may have litigation, regardless of what kind of rules you are thinking about that would deal with this point, and I would suppose that it would be useful to see whether or not that kind of potentially counter-productive and after-the-fact litigation could be headed off by having some type of uniform reporting requirements.

Chairman BOEHNER. The gentlelady's time has expired.

Ms. MAJETTE. Thank you.

Chairman BOEHNER. The Chair recognizes the gentleman from New York, Mr. Owens.

Mr. OWENS. Yes. Mr. John, I was particularly interested in some references you made to the savings and loan scandal.

Mr. JOHN. Yes.

Mr. OWENS. I am old enough to have lived through that here in Congress, and I remember it. There are a lot of people who benefit greatly from forgetting it. And even now, it is one of the best-kept secrets in history, in terms of exactly how much money the taxpayers of this nation paid to cover the savings and loan debacle.

For my edification, and also for the record, could you just tell me how much—to what degree this parallels the savings and loan situation, in terms of the responsibility of the Federal Government to bail out, how much of this is going to be our responsibility, and how much will be the responsibility of the private industry?

Mr. JOHN. Well, I think it is going to depend on when the problem happens. The S&L crisis didn't occur overnight, it took better than 8 years between the time that Congress first passed legislation that basically took it easy on the S&Ls, as far as their capital and other requirements, and the time that the industry went into serious crisis.

A similar thing is true with PBGC, and—

Mr. OWENS. Are we into that kind of cycle right now?

Mr. JOHN. Oh, I think—

Mr. OWENS. We call this “The Pension Underfunding Crisis: How Effective Have Reforms Been,” so we are in the crisis already, you would say?

Mr. JOHN. Oh, I think we are in the crisis, but I think we are in the early stages of the crisis. And if Congress had acted early in the stages, if Congress had acted in 1981, 1982 or so, to really seriously deal with the S&L crisis, there would have been problems, and there would have been some S&Ls that were fine, upstanding corporate citizens that would have gone down. But it wouldn’t have been the generalized problem that it ended up being.

This was a case where Congress saw a problem and made it much worse, aided by the economy and various and sundry other things. Similarly, with PBGC. PBGC is somewhat different in that it doesn’t receive an appropriation from Congress. But the simple fact is that if PBGC goes into a series of financial difficulties—and it very well could, for a variety of reasons—then essentially, you’re going to be up here having to deal with that question.

One of the problems with PBGC is the fact that somewhere around 61 percent of its assets are in government bonds. Now, no one is suggesting that those bonds would not be repaid on schedule, or anything along that line. But the future problems that PBGC will hit will come up at roughly the same time as the Social Security Administration starts to spend more than it takes in about 15 years from now, Medicare starts to have that problem a few years earlier than that, and then we come up with PBGC.

Now, there are government bonds in all of those cases, but you’re going to have three significant programs that are lining up at the Federal treasury, looking for additional money.

Mr. OWENS. You said that Congress appropriated the money for the S&Ls. Congress did not appropriate money for the S&Ls, they appropriated to bail out and back-up those that went bankrupt.

Mr. JOHN. They did. And most of the—like the Federal Savings and Loan Insurance Corporation—was funded by premiums up until the time that it ran into serious problems.

It also had a draw on the treasury, which PBGC does not have at this point, and they used that draw on the treasury first, before—

Mr. OWENS. So you would say that this crisis has about 15 years before it reaches its climax?

Mr. JOHN. I would say 15 years on the outside. I would suggest more along the lines of six to eight. And this is especially true if we continue to see people moving from one job throughout their career into a number of jobs throughout their career.

The sad fact is that the defined benefit pension plan has a lot of very positive features, but it doesn’t work very well when people move from job to job to job.

Mr. OWENS. So, if Congress is to learn from the S&L experience, you would say we should be taking some definitive action now, in order to avoid having a calamity 15 years from now?

Mr. JOHN. Absolutely, yes.

Mr. OWENS. Would anybody else care to comment on that? Actuary?

Mr. KRINSKY. Well, I don’t think, Congressman, that you were in the room earlier when I indicated what I thought were the differences, in that the PBGC's obligations to pay pension benefits out over a lifetime, or a very long time, while the S&L was liable to their depositors on demand.

So that I think we have—my—I would respond that this is something that needs continuous looking at, but I don't put it in the same category as crisis, that throughout its history, PBGC has had calculated deficits, but that compared to their assets, they are not overwhelming.

The second thing is—and Mr. Gordon, I'm sure, will remember, as well—that in the creation of the PBGC, these issues were discussed as possibilities. It would be interesting to look at old hearings in the creation in 1974 of these issues.

This is not an unanticipated situation, in that the PBGC, the pay-outs of the PBGC, again, from an actuarial point of view, are not risk-related, the same way—you can do life insurance, or how long a person will live. You don't have those kind of statistics on when companies are going to go out of business, or—and they are not—and they fluctuate with volatility, as to the economic situation.

So that it's very different, and this was an anticipated problem, in setting up the PBGC in the first place.

Mr. OWENS. My time is up, but I think you wanted—would Mr. Chairman allow him to make a comment? Did you have your hand up?

Mr. GORDON. Yes.

Mr. OWENS. Yes?

Mr. GORDON. Let me relate an example from the not-too-distant past, which gives rise to deep apprehension on my part, so that comparing it to the S&L situation or not is one thing, but here is a concrete example which, if it was multiplied, could lead to the kind of PBGC meltdown that we are all trying to avoid.

Many of you may remember the Chrysler bail-out of a number of years ago. It was put to the Congress by Mr. Iacocca that, absent that bail-out, Chrysler would terminate. After looking at all the numbers, Congress concluded that it was less expensive to bail out Chrysler than to bail out PBGC.

Now, if we have a number of situations like that taking place, we're going to have an inordinate stress on PBGC. And whether it is roughly equivalent at any particular point in time to the S&L crisis or not can be argued by the academics. But in the meantime, the practical problems that will be faced will be enormous.

I think that steps ought to be taken now to earthquake-proof PBGC. Don't wait for the earthquake to happen, don't try to predict whether it's going to happen. Take the steps now to try to earthquake-proof it.

Chairman BOEHNER. The gentleman's time has expired. And as you probably could tell, we have several votes on the House floor. Let me thank, once again, all of our witnesses for your excellent testimony and your help.

The Congress of the United States does, in fact, have a responsibility to act. We have been looking at this and dealing with this over the last several years. We have had a number of hearings, and I do think that we have a responsibility to do our job.

And that means taking a serious look at the issues in these defined benefit plans—and in the entire pension system, for that matter—to make sure that it is viable for the 21st century, that it works for employers who voluntarily offer these programs, and that it works to ensure the retirement security of American working families.

So again, thank you all. This hearing is adjourned.

[Whereupon, at 12:15 p.m., the Committee was adjourned.]

[Additional material submitted for the record follows:]

Statement of Hon. Charlie Norwood, a Representative in Congress from the State of Georgia

Thank you Mr. Chairman for holding today's hearing and this series of hearings on the pension crisis. I am very much looking forward to the testimony of our witnesses and I sure do appreciate their time and expertise in reviewing future solutions to this crisis.

In our last hearing we learned about the poor financial health of the Pension Benefit Guaranty Corporation (PBGC). For the past 20 years, we have taken steps to reform ERISA and prevent pension underfunding. Despite our efforts, the PBGC is staring down an $8.8 billion deficit. The PBGC is responsible for guaranteeing payment of basic pension benefits for 44 million American workers and retirees participating in some 30,0000 private sector defined benefit pension plans. Over the past year, the PBGC has assumed the obligations of paying out basic pension benefits for several large pension plans, and the agency's surplus has quickly evaporated.

What's very disturbing is that roughly 89 percent of pension plans are considered underfunded due to a number of factors including low interest rates.

What is it going to take to get things back on track? What is it going to take to make sure hard working Americans are not left penniless in their retirement? How do we prevent taxpayers from getting stuck with another S & L type bailout situation?

Today, I look forward to hearing our witness' thoughts on how the reforms of the past 20 years have helped and perhaps also handcuffed the defined benefits plans. How have these reforms effected the underfunding crisis? What can we do moving forward to ensure retirement security for hardworking families?

We have certainly taken some big steps in the right direction to protect pension plans since the Enron crisis.

I am a strong supporter of the Pension Security Act, H.R. 1000, which would give workers unprecedented new retirement security protections that would have helped protect thousands of Enron and WorldCom employees who lost their savings during their companies' collapses if the bill had been law.

Mr. Chairman, I was pleased to support the recent passage of your bill, H.R. 3108, the Pension Funding Equity Act of 2003. This bill will provide a short-term, two-year pension funding fix while we in Congress work to address the pension crisis and develop permanent solutions to these pension underfunding problems.

Thank you Mr. Chairman and I yield back.