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EXAMINING LONG-TERM SOLUTIONS TO REFORM AND STRENGTHEN THE DEFINED BENEFIT PENSION SYSTEM

HEARING

BEFORE THE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

OF THE

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

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

April 29, 2004

Serial No. 108-55

Printed for the use of the Committee on Education and the Workforce

Available via the World Wide Web: http://www.access.gpo.gov/congress/house
or
Committee address: http://edworkforce.house.gov

U.S. GOVERNMENT PRINTING OFFICE

93-386 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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EXAMINING LONG-TERM SOLUTIONS TO REFORM AND STRENGTHEN THE DEFINED BENEFIT PENSION SYSTEM

Thursday, April 29, 2004
U.S. House of Representatives
Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
Washington, DC

The Subcommittee on Employer-Employee Relations met, pursuant to notice, at 10:32 a.m., in room 2175, Rayburn House Office Building, Hon. Sam Johnson [Chairman of the Subcommittee] presiding.

Present: Representatives Johnson, Boehner, Wilson, Isakson, Kline, Carter, Andrews, Wu and Holt.

Staff present: Stacey Dion, Professional Staff Member; Kevin Frank, Professional Staff Member; Ed Gilroy, Director of Workforce Policy; Molly Salmi, Deputy Director of Workforce Policy; Deborah Samantar, Committee Clerk/Intern Coordinator; Kevin Smith, Communications Counselor; Jo-Marie St. Martin, General Counsel; Jody Calemine, Minority Counsel Employer-Employee Relations; Margo Hennigan, Minority Legislative Assistant/Labor; Michele Varnhagen, Minority Labor Counsel/Coordinator.

Chairman JOHNSON. A quorum being present the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce will come to order.

It's 10:30 and everybody is gone except two of us. The two stalwarts of the Congress, Rob Andrews and myself, and we appreciate you all's presence here this morning.

STATEMENT OF HON. SAM JOHNSON, CHAIRMAN, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Chairman JOHNSON. We're holding this hearing today to hear testimony on examining long-term solutions to reform and strengthen the defined benefit pension system. Under Committee rule 12B, opening statements are limited to the Chairman and ranking minority member of the Subcommittee. Therefore, if other members have statements, they will be included in the hearing record.

With that, I ask unanimous consent for the hearing record to remain open for 14 days to allow members' statements and other ex-

traneous material referenced during the hearing to be submitted in the official hearing record. Hearing no objection, so ordered.

Good morning to you all and welcome to the Employer-Employee Relations Subcommittee. Less than 3 weeks ago President Bush signed into law, as you know, the Pension Funding Equity Act, and that new law changed the interest rate we use as a bench mark for calculating how much money a pension plan can expect to earn on its assets.

Getting from introduction to enactment on that new law, took better than 6 months, and it wasn't a smooth or easy task, and that law expires in a year and a half or so. We just don't have time to sit back and relax and admire our handiwork. The job we have ahead of us is far more complex than simply replacing an interest rate.

Chairman Boehner and I said repeatedly we were working to introduce legislation that will significantly reform and strengthen the defined benefit pension system, and with the assistance of my ranking member, Rob Andrews, in this difficult job we'll get it done.

Over the last 20 years Congress has attempted several times to strengthen the defined benefit system, yet we're seeing record deficits at the Pension Benefit Guarantee Corporation, and under funding problems continue to threaten the future of the system.

Fundamental questions of long-term pension plan solvency are at the top of the list for reform. Expanding the number of pension plans and individuals in the plans will be important for insuring that Americans' retirement will be financially secure. And among the thorniest of issues we will face is replacing the interest rate to be used for lump-sum calculations, because it's still currently based on the 30-year treasury, which hadn't been issued since 2001, as you're aware.

If the interest rate chosen is too low, lump-sum distributions will be unjustifiably large at the expense of all other plan participants. However, if the rate is too high, those taking lump sums would be getting less than the equivalent of their annuity payment.

Other issues, such as deductibility of pension plan contributions, are integral to this effort but will fall within the jurisdiction of the House Ways and Means Committee, and since I'm on that Committee, as well, I'll look forward to working with Chairman Thomas on those issues, and I'm sure that Rob can help me in that too.

Mr. ANDREWS. Chairman Thomas or—

Chairman JOHNSON. Well, can he? Last summer the Bush administration proposed some major changes to the way that assets and liabilities are measured, and some significant changes to notice requirements were included. We've already held a joint hearing on those proposals with the Ways and Means Committee. Today we're holding the seventh hearing on this issue.

Our invited witnesses today will give us their suggestions on how this system could be improved. With that, I now yield to the distinguished ranking minority member of the Subcommittee, Mr. Rob Andrews.

[The prepared statement of Chairman Johnson follows:]

Statement of Hon. Sam Johnson, Chairman, Subcommittee on Employer–Employee Relations, Committee on Education and the Workforce

Good morning and welcome to the Employer–Employee Relations Subcommittee.

Less than three weeks ago, President Bush signed into law the Pension Funding Equity Act. That new law changed the interest rate we use as a benchmark for calculating how much money a pension plan can expect to earn on its assets. Getting from introduction to enactment on that new law took better than six months and it was not a smooth or easy task. That new law expires in about a year and a half.

We do not have time to sit back and admire our handiwork. The job we have ahead of us is far more complex than simply replacing an interest rate.

Chairman Boehner and I have said repeatedly that we are working to introduce legislation that will significantly reform and strengthen the defined benefit pension system. I welcome the assistance of my Ranking Member Rob Andrews and the full Committee Ranking Member George Miller in this difficult job.

Over the last 20 years, Congress has acted several times in attempts to strengthen defined benefit system and prevent pension underfunding, yet significant underfunding problems continue to persist that threaten the future of the defined benefit system. Workers should be able to count on their pension benefits when they retire, so the importance of this project cannot be understated. The defined benefit system needs long-term reform, and we have an obligation on behalf of workers and employers to move forward and act responsibly.

Fundamental questions of long-term pension plan solvency are at the top of the list for reform. Expanding the number of pension plans and workers in these plans will be important for ensuring that Americans' retirement will be financially secure. Among the thorniest of issues we will face, is replacing the interest rate used for lump sum calculations because it is currently based off of the 30–Year Treasury Bond which has not been issued since 2001. If the interest rate chosen is too low, lump sum distributions will be unjustifiably large at the expense of all other plan participants. However, if the rate is too high, those taking lump sums would be getting less than the equivalent of their annuity payment.

Other issues, such as deductibility of pension plan contributions, are integral to this effort but will fall within the jurisdiction of the House Ways and Means Committee and I look forward to working with Chairman Thomas on those issues.

Last summer, the Bush Administration proposed some major changes to the way that assets and liabilities are measured and funded as well as some significant changes to notice requirements. We held a joint hearing on those proposals with the Ways and Means Committee last July.

Today we are holding the seventh hearing on the issue of defined benefit pension system reform. Our invited witnesses today will give us their suggestions as to how this system should be improved.

STATEMENT OF HON. ROBERT ANDREWS, RANKING MEMBER, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Mr. ANDREWS. Thank you, Mr. Chairman, and thank you ladies and gentlemen. I'd like to thank the witnesses for their efforts in being with us today. Let me also say a special word for the pension community, much of which is gathered in this room this morning. We appreciate the diligence, substantive depth that the ladies and gentlemen who work on this issue bring to this process. I know both sides of the aisle have benefited from your advocacy and from the hard work that you do.

I enjoy this area because it is one of the areas of the law and policy where partisan divisions are not self-evident and need not be self-limiting, and I hope that we can approach this morning's hearing in that spirit.

We face two significant paradoxes in the pension law of our country. The first is that the plans that are the strongest and most dependable in our pension world are the ones that are receiving the least number of new adherents and new enrollees and, in fact, are losing ground. Those are defined benefit plans.

We did a lot of hearings in this Committee in the wake of the Enron and WorldCom scandals, and they were scandalous and painful episodes indeed. It's important to remember that the pension scandals that have dominated the first couple of years of this decade came in defined contribution plans; self-directed defined contribution plans not in defined benefit plans. Defined benefit plans are solid as a rock, and that is something to celebrate and be very proud of.

So I think that the first principle that we should apply in assessing the law that governs defined benefit plans is the Hippocratic Oath; we should first do no harm to a system that is very solid and very dependable for millions of retirees and their families.

The paradox is that these plans are so dependable but they're becoming so rare. Virtually no one is signing up to create a new one, and many employers are withdrawing from the ones that they are already in. And one of the issues that I want to explore in these hearings is why that is and what we can do about it.

I don't think we should ever mandate or coerce any union or any group of employers or any single employer to move toward defined benefit plans, but I think that we need to create an environment where that remains a viable choice. And I fear that that's not the environment that we're living in today.

The second paradox is that at a time when Americans are living longer and going to be requiring more of their private assets to maintain their standards of living there are 69 million American workers who have no private pension coverage at all. In 1999, Congressman Owens and I requested that the General Accounting Office do an assessment of the number of American workers who have no private coverage at all, and that was the report that the GAO gave us.

Now, that is both material to today's discussion but also separate from today's discussion. Obviously, legal parameters that would make it more attractive for employers and unions and employee groups to create pension plans will reduce the number of those without a pension. But I believe that those incentives alone are not sufficient to address the concerns of workers who are in low-margin industries, at low salaries, whose employers may well have the desire to fund a pension for those workers but don't have the discretionary net income to do so.

Although it's within jurisdiction of my friends of the Ways and Means Committee, it's important that we keep in mind the various proposals that have been made for refundable tax credits for low-income workers, so that we can vigorously subsidize savings for workers who do not have a private pension.

The paradox, again, is that the miracle of medical technology means that many Americans are going to be living to be 90 or 100 years old. Now, the fastest growing demographic in the 2000 Census was the cohort of people between 80 and 90 years of age. That grew by 33 percent relative to the 1990 Census, which I think is great news for all of us.

The problem is that we have a pension system that's still rather predicated on the idea that you're going to live for about 7 years after you retire. Happily, that's no longer the case, but we're heading toward a day when we're going to have an awful lot of retirees

living at or near the poverty line or beneath it. And one of the ways to confront that problem is to have a more robust and inclusive pension system.

So I look forward to having these and other questions addressed, and I, again, thank both panels of witnesses for their time this morning.

Chairman JOHNSON. Thank you. I appreciate your comments, and I tell you what. It is important to note that I think the insurance industry has already moved their final, you know, date at which they stop collecting and figuring things from about 96 or 100 to 120. So, you know, it surprised me a little bit, because the doc told me I was only going to live to 104. Longer, huh, OK.

Well, let's get started. Our first panel for today's hearing will focus on reforms to the single employer pension system, and they are Kenneth Kent, who is vice-president for pension issues of the American Academy of Actuaries. Greg Heaslip, who is vice-president for benefits at PepsiCo, Inc. Mark Iwry, who is non-resident single—or excuse me—senior fellow of the Brookings Institution.

I'll introduce the second panel after they're seated, and before the witnesses begin the testimony, I'd like to remind members that we'll ask questions after the entire panel has testified. In addition, the Committee rule two imposes a 5-minute limit on all questions. And there are lights down there, which will be green, yellow, and red, which will indicate to you five, one, and zero. So I'd appreciate your remarks remaining within the 5-minute limit, as well.

I'll recognize you at this time. Go ahead, Mr. Kent.

STATEMENT OF KENNETH A. KENT, ACADEMY VICE-PRESIDENT, PENSION ISSUES, AMERICAN ACADEMY OF ACTUARIES, WASHINGTON, DC

Mr. KENT. Thank you, Chairman Johnson, Ranking Member Andrews, and distinguished Committee members. Thanks for the opportunity to testify today on pension reform and thanks for that introduction.

I'm here representing the American Academy of Actuaries. The Academy is a non-partisan, public policy organization for all actuaries in the United States. In my testimony today I'll address three items—the need for reform; the Academy's principles for reform; and opportunities for change in our system of benefit delivery.

Do we need reform? The need is evident by the continuing decline in the number of defined benefit plans. Defined benefit programs are a fundamental vehicle for providing financial security for millions of Americans. Unlike other programs, they provide lifetime benefits to retirees, no matter how long they live and regardless of how well they do on their individual investments.

However, recent market conditions of low interest rates and low market returns have caused more dramatic declines in the number of covered employees. There are many contributing factors, including regulatory and administrative burdens derived from years of amendments to ERISA, which have had a long-term detrimental impact. These programs need your support through major reform of the current laws.

Our reform principles. Leading actuaries volunteered their time and intellectual capital to create a framework of principles for

funding reform. We will be publishing a paper, presenting many of the ideas on how these principles can be addressed, some of which are included in the summary that is attached to my statements.

Let me briefly describe the six principles. Solvency. This should be a fundamental objective of funding reform. The rules should move us to a point where assets cover liabilities. They should also address and reward responsible corporate behavior.

Predictability. Contributions should be more predictable so they can be budgeted in advance. Excessive precision at the cost of rational predictable results can be expensive for employers and detrimental to employees.

Transparency. Users of the information should be able to understand the current financial position of the pension plan. However, we should not confuse the need for financial disclosure with the measurements to identify long-term funding obligations.

Flexibility. Sponsors should be encouraged to fund their plans better by allowing them to buildup margins in their plans without deduction and excise tax problems and providing excess surplus for other employee benefit purposes without reversion tax.

Simplicity. The rules should be easier to understand and comply with. And, transition, sponsors need a smooth transition to the new rules so that they are not forced into freezing or terminating their pension plans.

Reform is also an opportunity to bring our retirement system in line with the changing demographic and global business model. There are five areas that can help. Put hybrid plans back on the table. Their popularity stems from an ability to meet the needs of participants and employers alike, especially, within some industries.

Provide phased retirement. Our workforce can use this gradual retirement process which makes these provisions a win, win for employers and employees. Mirror the opportunity available in defined contribution plans by allowing employee deductible contributions to defined benefits plans and allow employees access to purchase lifetime income through their employer plans.

Provide portability. Multi-employer plans provide one-time-tested-effective model. IRAs go part way but the challenge is portability of annuity-type benefits to preserve the intended security. Defined benefit plans have a critically different function for retirement security over lump sums through investment and longevity risk pooling.

Update the standard retirement age. In the 1930's when life expectancies were much lower, age 65 was defined. Clearly, our society has changed, and this target should be changed to better align the expectations of the workforce today and in the future.

I appreciate the opportunity to participate in this process on behalf of pension actuaries who have dedicated their careers to helping sponsors provide employees' retirement security. To this end, we're currently engaged in completing a white paper on ideas on reform, analyzing ways to redefine retirement age, establishing a national security as a bench mark.

As we work to further define these principles, we will share them with you. Thank you for the opportunity on behalf of the American Academy of Actuaries.

[The prepared statement of Mr. Kent follows:]

Statement of Kenneth A. Kent, Academy Vice President, Pension Issues, American Academy of Actuaries, Washington, DC

Chairman Johnson, Ranking Member Andrews, and distinguished committee members, I thank you for the opportunity to testify today on "Examining Long-Term Solutions to Reform and Strengthen the Defined Benefit Pension System." My name is Ken Kent, and I am the Vice President of the Pension Practice Council of the American Academy of Actuaries. The Academy is the non-partisan, public policy organization for all actuaries in the United States. In my testimony today, I will address three specific items related to pension funding reform:

- The need for reform;
- The Academy's principles for reform; and
- Opportunities to change our system of benefit delivery

Do we need reform?

The need for reform is evidenced by the continuing decline in the number of defined benefit plans. Defined benefit programs are a fundamental vehicle for providing financial security for millions of Americans – unlike other retirement programs, they provide lifetime benefits to retirees no matter how long they live and regardless of how well or poorly they do with their investments. However recent market conditions of combined low interest rates and low market returns have made it difficult for employers to maintain these plans and have instigated more dramatic declines in the number of employees covered under these plans over the past year. There are many contributing factors, including regulatory and administrative burdens derived from years of amendments to ERISA, which have had a long-term detrimental impact. These programs need your support through major reform of the current laws.

Our Reform Principles

Leading actuaries volunteered their time and intellectual capital to create a framework of principles that we believe funding reform should meet. We will soon be publishing a paper presenting many ideas on how these principles can be addressed – some of which are included in a summary, which is attached to my written statement.

Let me briefly describe these six principles:

- Solvency – This should be a fundamental objective for funding reform – the rules should move us to a point where assets cover liabilities. They should also address and reward responsible corporate behavior over short-term economic cycles.

- Predictability – Contributions should be more predicable so they can be budgeted in advance. Precision at the cost of rational, predictable results can be expensive for employers and detrimental for employees.

- Transparency – Users of the information should be able to understand the current financial position of the pension plan. However, we should not confuse the need for financial statement disclosure with measurements to identify the funding obligation of a long-term program.

- Flexibility – Sponsors should be encouraged to fund their plans better by allowing them to build up margins in their plans without deduction and excise tax problems and by providing them access to "super surpluses" for other purposes, such as employee benefits, without having to pay a reversion tax.

- Simplicity – The rules should be easier to understand and comply with than the current, complex rules.

- Transition – Sponsors need a smooth transition to the new rules, so they are not forced into freezing or terminating their pension plans.

Opportunity to update benefit delivery

Reform is not only a responsibility but also an opportunity to bring our system of retirement security in line with a changing demographic and global business model. There are five areas that can help achieve our current and future needs:

- Put hybrid plans back on the table. Their popularity stems from an ability to meet the needs of participants and employers alike, especially within some industries.

- Provide for phased retirement. The current rules are an impediment. Our workforce can use this gradual process of retirement, and individual flexibility makes these provisions a "win-win" with employers.

- Mirror the opportunity available for defined contribution plans by allowing for employee deductible contributions to defined benefit plans and by allowing employees access to purchase lifetime income security through employer sponsored plans.

- Provide portability. Multiemployer plans provide one time-tested, effective model – IRAs go partway – but the challenge is portability of annuity-type benefits to preserve the intended security. Defined benefits have a critically different function for retirement security over lump sums, through investment and longevity risk pooling. Placing restrictions on lump sums and/or encouraging participants to take annuities are two possible approaches.

- Update the standard retirement age. In the 1930s, when life expectancies were much lower, age 65 was defined as the standard retirement age. Clearly, our society has changed, people are living significantly longer, and this target age should be raised to better align the expectations of the workforce today and in the future.

I appreciate the opportunity to participate in this process on behalf of pension actuaries who have dedicated their careers to helping sponsors provide employees' financial security on retirement. To these ends, we are currently engaged in:

- Completing a white paper with our ideas on pension reform;
- Analyzing ways to redefine what retirement age should mean; and
- Encouraging the establishment of a national retirement security policy as an overall guiding benchmark.

As we work to further define these principles and alternatives for reform, we will share them with you. Thank you for this opportunity on behalf of the American Academy of Actuaries.

Pension Funding Reform for Single-Employer Plans[1]

The economic challenges of the past four years have tested U.S. pension funding rules like no other time since the funding rules were enacted. The unprecedented severe combination of declining interest rates and equity values have increased liabilities and decreased asset values simultaneously — cutting funding ratios almost in half between 2000 and 2003.

Different constituencies are unhappy with the pension funding rules, and most would agree that the current rules are unnecessarily complex and lacking in transparency.

- *Employers* assert that the rules create volatile contribution requirements that are counter to their business cycles and that unpredictable results make it difficult to plan ahead.
- The *Pension Benefit Guaranty Corporation (PBGC)* is concerned about its dramatically increased deficit and the funding rules that allow sponsors of underfunded plans to completely offset contributions by a credit balance and not avoid paying variable PBGC premiums. They would prefer that contributions respond quicker to changing economic conditions.
- *Participants* in terminated plans with large benefits were surprised at how poorly funded their plans were, and how much that reduced their PBGC-payable benefit.

The American Academy of Actuaries'[2] Pension Committee has identified several principles that any revision of pension funding rules should meet. These principles are the result of an ongoing discussion and are likely to change and evolve as discussions continue. The primary objective of pension funding is solvency. Participants and the PBGC are benefited by well-funded pension plans. Recent proposals by both the Bush administration and Congress recognize that satisfying each of the principles the committee has defined is a balancing act. Members of the committee do not want insolvent plans, nor do they want an over burdensome solution to eliminate defined benefit (DB) plans. Employees could easily be hurt more by a freeze or termination of a DB pension plan than by occasions of insolvency. In addition, PBGC's deficit will be difficult to eliminate if healthy employers drop their pension plans and stop paying premiums to the PBGC. Thus, as typically happens, balance is needed when applying any principles for reform.

There are two likely approaches to reforming the funding rules: incremental or comprehensive. Both have advantages and disadvantages, and both will provide substantial challenges. Incremental change may get enacted sooner, but each change

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[1] This paper covers fundamental principles for the reform of single-employer plans. A paper, yet to be published, will examine the reform of multiemployer plans, since those plans are so different.

[2] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

will have opponents that request exceptions and transition rules, increasing the opportunity for future problems. On the other hand, a comprehensive rewrite of the funding rules may take longer to enact and may result in unforeseeable problems that occur only when tested in future economic climates. Whether reform is incremental or comprehensive, all proposals for pension funding should be assessed to see how they meet the following principles:

- **Solvency:** The funding rules should move us to a point where assets cover accrued liabilities. The funding rules could also encourage employers to ensure that assets cover ongoing liabilities.

- **Predictability:** Contributions should be more predictable so they can be budgeted in advance.
    - *Smooth contributions/less volatility:* Contributions should not change radically due to a small change in assets or interest rates.
    - *Accommodate (recognize?) business/economic cycle:* Employers should be able to make larger contributions in good years than under current rules, so they will not have to contribute large amounts in difficult years.
    - *Better financial risk management:* Plan sponsors should be able to hedge swings in liabilities by holding bonds, which would make contributions more predictable.

- **Transparency:** Users of the information should be able to understand the current financial position of the pension plan and its integration with the sponsors' disclosures.

- **Incentives to fund/flexibility:** Sponsors should be encouraged to fund their plans better by allowing them to build up margins in the plan without deduction and excise tax problems and by providing them access to "super surpluses" for other purposes, such as employee benefits, without having to pay a reversion tax.

- **Avoidance of moral hazards:** The rules should not encourage weak employers to improve benefits at the expense of someone else (e.g., the PBGC, premium payers, or US taxpayers).

- **Simplicity:** The rules should be easier to understand and comply with than the current, complex rules.

- **Transition:** Sponsors need a smooth transition to the new rules, so they are not forced into freezing or terminating their pension plans.

It will be recognized that there are inherent challenges in coordinating several of these items, and of course, no specific legislative approach can be firmed up until the necessary choices are made. We have, however, prepared a table appended to this summary that offers suggestions that could improve each of the matters noted above; this table necessarily includes suggestions that conflict with one another, just as the potential goals do. This should be kept in mind when reviewing the table.

The Academy's Pension Committee is engaged in the development of an issue brief that expands on the way these principles can be addressed, as well as a more technical white paper that discusses how the current rules and regulations hinder achievement of these principles and offers alternative ways the law can be changed to realign the rules.

Why should defined benefit plans be encouraged? Defined benefit plans, in particular, can reduce the investment, inflation, interest rate, and leakage[3] risks to employees and eliminate most of the longevity risk through pooling (annuitization). Employees are much more likely to participate in the company DB plan and they are much more likely to get a lifetime income from the DB plan. (Most defined contribution (DC) plans such as 401(k)s rely on voluntary enrollment, and rarely pay out a lifetime income.) In addition, DB plans are better than DC plans at providing the country with some very important advantages, which many people (including some policymakers) will not realize are lost until many years from now, when it is too late to regain them. For example, DB plans create a more financially secure population, reduce welfare expenditures, provide a huge source of efficiently invested assets in our markets, and defer taxable income to the future when it is needed (to reduce the strain on federal resources caused by retiring baby boomers, for example). And finally, DB plans help employers with workforce management issues (and union demands) better than DC plans.

Prior law encouraged DB plans as much as DC plans. This is no longer true. DC plans now have more tax advantages, and the laws regulating them are much simpler and they allow DC plans more flexibility (e.g., pre-tax employee contributions, employer matches, tax advantages for company stock contributions). Thus, any revisions to the funding rules should stop and reverse this trend, or employers will continue to switch to DC plans. Many employers have already done that (particularly ones that were intending to switch to cash balance plans but were too concerned about the current, uncertain legal environment), and many are freezing their DB plans while contemplating moving to DC plans.

We welcome the opportunity to discuss these ideas with you and to work with you in shaping a solution that will balance the needs of employees, employers, the PBGC, and other parties.

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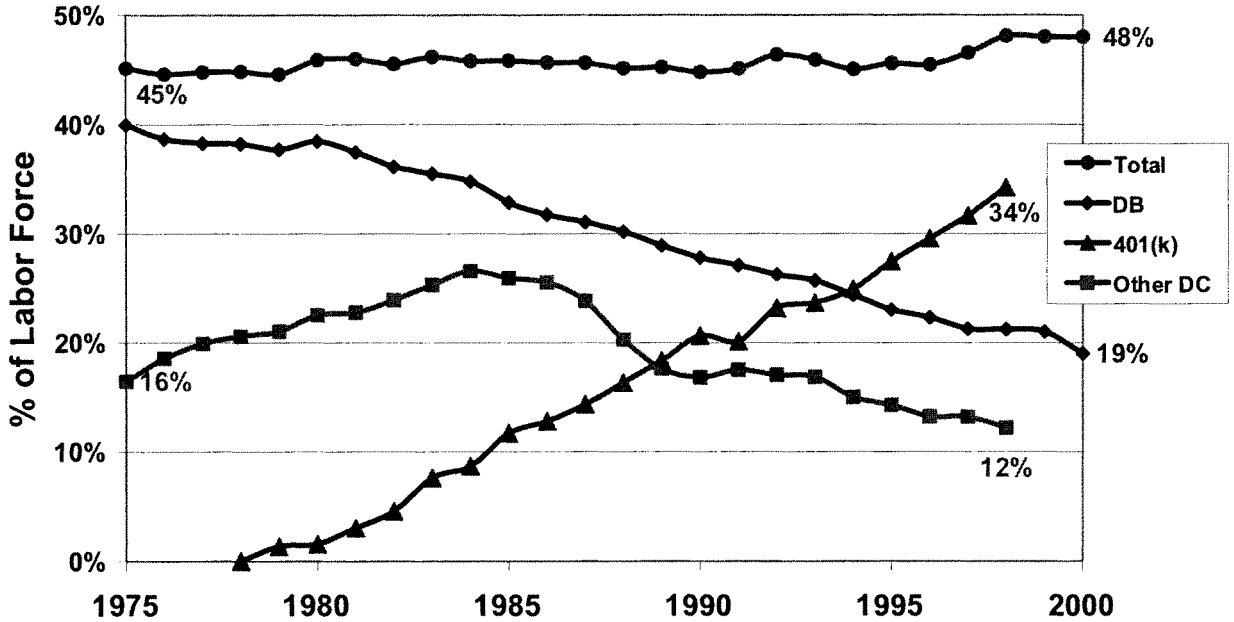
[3] "Leakage" refers to the risk that retirement assets will be withdrawn and spent before the employee retires, and will therefore not be available for retirement income.

Principles	Possible Alternatives for Funding Reform (see advantages/ disadvantages in our paper)
Solvency The funding rules should move us to a point where assets cover accrued liabilities. The funding rules could also encourage employers to ensure that assets cover ongoing liabilities.	• The full funding limit override could be increased to 100 percent of current liability (CL), to ensure contributions and variable premiums up to that amount. • Require a normal cost (or present value of accruals) until assets reach a higher threshold (e.g., the greater of the ongoing actuarial accrued liability or 130% of CL). • Allow or encourage normal cost (or present value of accruals) until assets reach a still higher amount, such as total present value of benefits, a termination liability, or 150% of CL. • Instead of requiring weak sponsors to use mandated retirement assumptions (which can easily be inappropriate), require them to explain the basis of their retirement assumption for CL calculations. • For shutdown benefits that are too difficult to fund, phase-in the guaranteed benefit from shutdown date, charge a PBGC premium for them, or require security for them. • Include lump-sum subsidies in current liability, and allow plans to gradually eliminate the subsidy. • Gradually restrict the use of the credit balance from fully offsetting the contribution for plans funded below a certain level.
Predictability Contributions should be more predictable, so that they can be budgeted in advance. *Smooth contributions/less volatility* Contributions should not change radically due to a small change in assets or interest rates. *Accommodate business/economic cycle:* Contributions could be greater in good years so they can be less in difficult years. *Better financial risk management* Plan sponsors should be able to hedge swings in liabilities by holding bonds, which would make contributions more predictable.	• Make the deficit reduction contribution (DRC) and regular §412(b) funding rules more similar. For example: - Shorten the §412(b) amortization periods. - Increase DRC "amortization" periods, especially if smoothing in the interest rates is reduced. - Bring the discount rates for the DRC and regular funding rules closer together. • Eliminate the need for the regular funding rules in §412(b) by extending the DRC rule to 100% of CL. Assess whether this will weaken funding in other economic scenarios. • Enable bond-immunized plans to hedge their interest rate risk and contribution volatility by allowing them to elect to use market value of liabilities (in addition to market value of assets), when subject to DRC. • Cap the increase in the minimum contribution at 25% of the plan's normal cost (or 2% of the plan's accrued liabilities, if greater)
Transparency Users of the information should be able to understand the current financial position of pension plan and sponsor.	• Require timely (year-end disclosure as required in financial statements) and meaningful (market value) disclosure of assets, liabilities, and funding ratios to participants if plan is funded below 100% of accrued liabilities.

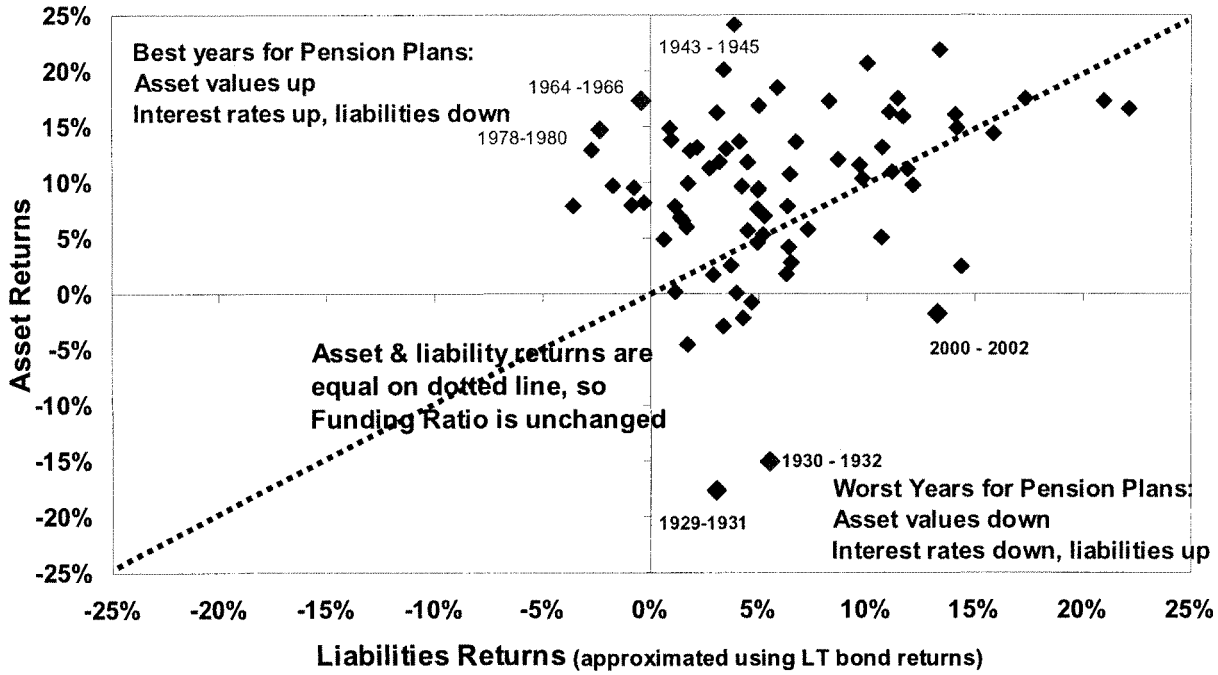
Principles	Possible Alternatives for Funding Reform (see advantages/ disadvantages in our paper)
Incentives to fund/flexibility Sponsors should be encouraged to fund their plans better by allowing them to build up margins in the plan without deduction and excise tax problems, and by allowing them access to super surpluses for other purposes, such as employee benefits, without reversion tax.	• Improve plan asset margins by increasing deductible limits (e.g., to the greater of 150% of CL and the full funding limit). • Expand the §420 transfer rules to allow super surpluses (above a high threshold) to be used for other employee benefit plans, such as employee health and other retirement plans. Require union approval if pension plan is subject to bargaining. • Let PBGC variable premium be negative to reduce some of the per person premium for very well funded plans.
Avoidance of moral hazards The rules should not encourage weak employers to improve benefits at the expense of someone else (e.g., the PBGC, premium payers, or US taxpayers).	• Shorten the amortization periods for amendments. • Tighten rules for sponsors whose underfunding is large in proportion to their net worth, earnings, or cash flow. For example: tighten threshold for providing security before allowing benefit improvements; freeze future benefit accruals, grow-ins; and eliminate lump sums if plan is very underfunded. • Allow plans to eliminate lump sums (as long as they replace it with a 20-year-certain joint life benefit). • Improve PBGC's position in bankruptcy proceedings.
Simplicity The rules should be easier to understand and comply with than the current, complex rules.	• Have just one amortization period or one funding rule. • Disconnect minimum funding rules from maximum deductibility rules. • Allow changes in funding methods whenever desired. • Eliminate quarterly contributions, and require the full contribution by year-end. • Discuss alternatives to the yield curve proposal.
Transition Sponsors need a smooth transition to the new rules, so that they are not forced into freezing or terminating their pension plans.	• Cap the increase in the minimum contribution at 25% of the plan's normal cost (or 2% of the plan's accrued liabilities, if greater)

Chart I - Participation Rates in Pension Plans (by type)



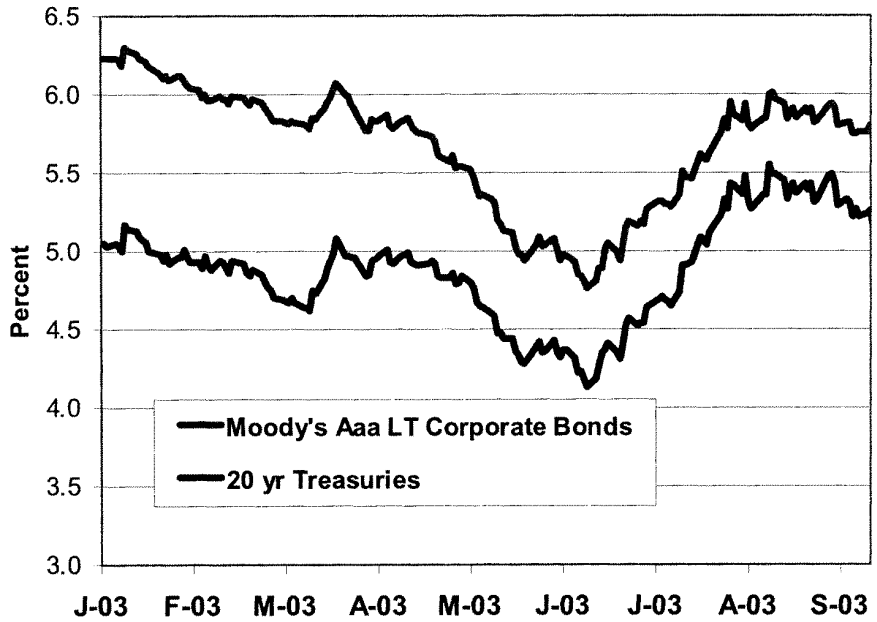
It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4, E8, & E23, and NCS for 1999 & 2000.

Asset & Liability Returns (over last 78 years)
3 year averages



This chart show how unusual the past few years have been (only the Depression was worse).
The smoothing rules would work at the other 96% of periods.

Chart III - Daily Interest Rates



Interest rates increased by 150 basis points in summer of 2003, making contributions volatile and unpredictable - contributions calculated in June 2003 would be dramatically different from those of just 7 weeks earlier, unless funding rules allow smoothing (or plan has duration matching bonds).

Chairman JOHNSON. Thank you, sir. We appreciate your testimony. Mr. Heaslip, you will be recognized.

STATEMENT OF GREG HEASLIP, VICE-PRESIDENT, BENEFITS, PEPSICO, INC., PURCHASE, NY

Mr. HEASLIP. Thank you. Mr. Chairman—

Chairman JOHNSON. Thank you for coming all the way down from New York. That's a tough road.

Mr. HEASLIP. No problem at all. Thank you. I'm pleased to be included in the hearing this morning. My name is Greg Heaslip. I'm the vice-president of benefits for PepsiCo.

Chairman JOHNSON. Turn on your mike. Will you push the button on it.

Mr. HEASLIP. How's that?

Chairman JOHNSON. That's perfect.

Mr. HEASLIP. Good morning and thank you for inviting me this morning. My name is Greg Heaslip. I'm the vice-president of benefits for PepsiCo. I'm also on the board of the ERISA industry Committee. I'm here this morning representing PepsiCo.

Mr. Chairman, before I begin my remarks this morning, I'd like to say a thank you to the Subcommittee for their leadership on replacing the 30-year treasury rate. That was something that's extremely critical to plan sponsors, such as us, and I think your tenaciousness and persistency on that issue were critical in getting it over the goal line, so thank you very much for that.

One of the reasons that the Pension Funding Equity Act is important to planned sponsors is that at least for the next 2 years we now have a reasonable basis on which to estimate our funding requirements. This certainty is very important from a planning and budgeting aspect for any plan sponsor.

Secondly, as it uses a public readily available interest rate to determine liabilities, there's a level of simplicity and transparency to the rate that appeals to us very much. And then, third, because the rate is based on a 4-year average instead of a spot rate there's some stability and predictability in our funding requirements, which is also appealing to plan sponsors.

Certainty, predictability, and stability are things that you'll hear me reiterate during my testimony this morning. At PepsiCo and at other plan sponsors, defined benefit pension plans have grown to a size where they have a material impact on the company's overall financial results.

Our pension expense impacts our profits, our share price. Funding impacts our balance sheet and our credit rating. For any expense of a magnitude of a pension plan, companies have to know in advance for the next three to 5 years what costs and funding requirements will be with reasonable certainty.

Recently, this has been almost impossible with defined benefit pension plans. It's partly due to the market, but it's also partly due to the complexity, frequent changes, and sometimes lack of guidance in these areas. It's really not the cost of defined benefit pension plans that scares companies. We understand that and that's what we signed up for while we implemented them. It's the unpredictability, the volatility, and the uncertainty surrounding them that makes them very, very difficult and challenging to sponsor.

I'd suggest that the way to strengthen our defined benefit system, our pension system in general, is to enact reforms that do three things. Provide greater certainty and predictability to planned sponsors, reduce the complexity inherent in today's rules, and maintain flexibility for plan sponsors to make changes that are in the interests of their businesses and workers.

Some specific recommendations I would suggest include, one, permanently replacing the 30-year treasury rate with a long-term corporate bond rate that is averaged over a three to 5-year period similar to what we have in place today. I would recommend using that rate for funding, lump-sum distributions, and PBGC premiums, eliminating some of the complex and contradictory rates that we use today.

I'd encourage companies or I'd provide companies the flexibility to make higher tax-deductible contributions than current law provides and to eliminate the excise tax penalty so that when times are good and business conditions permit we can build a cushion of funding in our plans and provide for longer-term benefit security.

I would maintain plan sponsor flexibility to change or modify their plans without mandates as to future benefits. We should never abandon the principle that what somebody has earned in a defined benefit plan is protected, but we shouldn't—in a voluntary system we shouldn't mandate what sponsors can do or can't do in the future.

Finally, in the area of disclosures, I would ask that you proceed cautiously. The pension literacy rate among our workers is not high. While we need to share important information, we also want to avoid creating undue anxiety or confusion among plan participants.

Again, thank you for the opportunity this morning. We believe strongly in defined pension plans—defined benefit pension plans at PepsiCo and in the work you're doing, and we look forward to a continued partnership in this important area.

[The prepared statement of Mr. Heaslip follows:]

Statement of Greg Heaslip, Vice President, Benefits, PepsiCo, Inc., Purchase, NY

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to participate in today's hearing. My name is Greg Heaslip and I am Vice President of Employee Benefits for PepsiCo, on whose behalf I am speaking today.

PepsiCo is a food and beverage company headquartered in Purchase, NY with 143,000 employees, including 60,000 employees in the U.S. PepsiCo's annual revenues are about $27 billion; we are ranked number 62 on the Fortune 500 list of large corporations.

PepsiCo sponsors several savings and retirement plans for its employees, including a defined benefit pension plan, defined contribution plan with employer matching contributions and broad-based stock option program.

My focus this morning is the defined benefit pension plan, and some of the challenges and opportunities faced by PepsiCo and by defined benefit plan sponsors in general.

As you know, defined benefit pension plans provide a unique and valuable set of advantages to both plan sponsors and their employees. For employers, the plans are an effective means of attracting and retaining a capable workforce. For employees, the advantages of defined benefit plans include:

- Automatic participation - Employees do not have to enroll or contribute a part of their wages in order to receive benefits.
- Benefit security. The plan sponsor bears the investment risk. Employees are protected from bad investment decisions and market fluctuations. Benefits are at least partially guaranteed by the PBGC, which is funded by plan sponsors.

- Lifetime income. Plans provide regular monthly income to participants and their spouses for life.

Given the well-documented lack of personal savings in this country, the growing cost of health care, the decline in employer-provided retiree medical benefits, stock market volatility, and longer life spans, defined benefit pension plans provide a unique and secure source of retirement income for more than 42 million American workers and family members.

Nonetheless, recent cost increases for these plans have been challenging for all plan sponsors. PepsiCo's experience is a case in point:

- Over the past three years PepsiCo's U.S. pension expense has risen from $26 million to $135 million, an increase of 500%.
- During the same period, PepsiCo has contributed $1.6 billion to its plans in order to maintain a reasonable funded status in the face of shrinking assets, due to a down equity market, and growing liabilities, driven by historically low interest rates.

In addition to rapidly rising costs and funding requirements, plan sponsors have had to cope with several trends that create a difficult climate for defined benefit plans in general. Continuation of these trends will inevitably discourage the use of defined benefit plans:

- Growing Uncertainty—The uncertainty around the replacement for the 30-year Treasury rate is an example of how unsettled the landscape is. Without knowing the basis for determining funding liabilities, plan sponsors could not accurately plan or budget. Analysts speculated what a company's liabilities might be, adding an element of risk to stock valuations. Uncertainty drives plan sponsors toward more predictable, stable alternatives such as defined contribution plans.
- Loss of Plan Sponsor Flexibility—Companies are increasingly concerned about their ability to change their plans, or adopt newer forms of defined benefits plans, in order to manage their costs or better meet the needs of a changing workforce. Some legislative proposals would impose unreasonable grandfathering requirements on plan sponsors who make plan changes, despite the voluntary nature of our pension system. Conversions to hybrid defined benefit pension plans have been attacked in the courts, media and legislature. Again, the result is the abandonment of defined benefit plans.
- Growing Complexity—Pension funding rules have become so complex that even those of us who manage these plans have difficulty understanding them. In addition, pension accounting and funding follow different standards and are barely integrated. This nearly-overwhelming complexity drives plan sponsors to abandon defined benefit plans for more transparent approaches, such as those offered in the defined contribution arena.

PepsiCo has been fortunate to weather this combination of volatility, uncertainty and complexity with its plans intact. We remain committed to defined benefit pension plans. However, that is not necessarily the case with all employers:

- The number of defined benefit plans insured by the PBGC decreased 70% from 114,500 in 1985 to 33,000 in 2002.
- In the three most recent years reported—1999 to 2002 the number of plans decreased 20%.

I believe there are a number of moderate reforms which, if enacted, could substantially improve the climate for defined benefit plans. The overriding objective of reform should be to strengthen and encourage growth of defined benefit pension plans. From a plan sponsor perspective this can be accomplished by reforms that provide greater certainty and predictability, maintain flexibility for plan sponsors and attack some of the complexity that exists today.

Allow me to suggest some reforms which may accomplish these goals:

Permanent Replacement of the Discount Rate for Liabilities

Congress is to be commended for its bipartisan support and timely passage of the Pension Funding Equity Act earlier this month.

The composite corporate bond rate contained in the Act provides needed clarity and certainty to plan sponsors. Going forward, I believe that the corporate bond rate as contained in Act is worth continuing on a permanent basis.

- It leads to a more reasonable (though conservative) approximation of liabilities than the defunct 30-year Treasury rate.
- It is readily available to the public.
- It is largely immune from the consequences of public policy decisions and from manipulation.

In addition, the use of a four year average, as currently provided for, is significantly less volatile than a "spot rate" would be, yet tracks the market.

In order to reduce some of the complexity inherent in today's defined benefit plans, this rate should also be used for other plan purposes such as calculation of lump sum distributions and determining variable PBGC premiums. I'll say more on this in a moment.

The relevance, accessibility and relative stability of this approach to pension funding make it appealing as a permanent reform.

Use of a yield curve, on the other hand, appears to lack many of the benefits of the corporate bond rate and may create new issues. While there are still many questions on exactly how a yield curve would work, potential issues with this approach include:

- The rate which would not be transparent, widely used or available to the public.
- The rate would be more volatile—leading to more volatile funding requirements—unless some average or smoothing is introduced. This seems somewhat inconsistent with the concept of a yield curve and would make it even more complex.

Plan sponsors would face increased uncertainty and funding volatility as a result. As indicated earlier, when faced with uncertainty or financial requirements they cannot adequately control, plan sponsors will tend to abandon defined benefit plans.

Addressing Complexity

One of the most daunting challenges facing defined benefit plan sponsors is the increasingly complex regulatory environment for these plans. The calculation of plan liabilities provides a perfect example. For funding purposes, plan sponsors are required to calculate liabilities four different ways, using three different interest rates. The liability figure actually used for funding can change from year to year based a number of factors. Pension expense is calculated using two interest rates, each of which is different from the rates used for funding. Lump sum distributions to participants are determined using yet another rate, the now-defunct 30 year Treasury rate. And variable rate PBGC premiums are based on a liability calculation that is different from all of the above.

Multiple stakeholders with vested, but differing interests in pension plans have produced a patchwork of non-integrated requirements. Sheer complexity is driving many plan sponsors to simpler, more transparent types of retirement plans. The current situation begs for Congressional leadership to bring the various stakeholders together to create simplifying reforms.

Higher Funding Limits

Employers should have flexibility to make larger funding contributions when business and economic conditions permit. Raising funding limits and eliminating the excise tax penalty benefits participants, employers and the PBGC. When economic conditions inevitably worsen, the added cushion resulting from large contributions provides participants with increased security, employers with lower required contributions and the PBGC with less risk.

Plan Sponsor Flexibility

Legislative reforms should preserve the ability of plan sponsors to change or modify their pension plans, so long as they observe the longstanding requirement that benefits which participants have already earned will be protected. Legislation requiring plan sponsors to offer participants a choice of plans or to grandfather future benefit flies in the face of our voluntary system. Mandates lead to loss of flexibility and control for plan sponsors. The inevitable result will be more harmful than helpful to workers, as employers will avoid both traditional defined benefit plans and some of the newer alternatives that have been developed.

Disclosure

I would urge Congress to act cautiously when considering new disclosure requirements.

I certainly support the goal of sharing meaningful information with participants, analysts and shareholders that enables them to make informed decisions about the company or take appropriate action. However, disclosures that create needless anxiety or confusion do more harm than good.

Several of the Administration's proposed disclosures fall into this category. For example, disclosing a plan's termination liability is likely to alarm participants, even though the plan may be well funded and the plan is not being terminated. Similarly, public disclosure of plans that are "under-funded" by more than $50 million could be meaningless, or even misleading, in the context of large plans and insufficient relative to small plans.

Both the spirit and practical outcome of proposals such as these would be to discourage the continuation of defined benefit plans. Ultimately, onerous and poten-

tially misleading new disclosures would be to disadvantage the very group they are designed to benefit—plan participants.

Conclusion

Mr. Chairman and members of the Subcommittee, thank you again for the opportunity to express my views on reforms that will strengthen the defined benefit pension system. With your leadership and with the involvement of key stakeholders, I am confident that we can improve the climate for this vitally important element of our retirement system.

Chairman JOHNSON. Thank you, sir. I appreciate your outline as a matter of fact. You two are pretty close together. Mr. Iwry, you may begin your testimony now.

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

Mr. IWRY. Thank you, Mr. Chairman. Chairman Boehner, Ranking Member Andrews, distinguished members. After spending much of the previous decade in the Treasury Department, overseeing the regulation of defined benefit and defined contribution plans and other employee benefits and after participating in the effort 10 years ago to reform the pension funding rules and shore up PBGC's financial situation as it was then, I will tell you that probably the single most effective step that you could take to strengthen the defined benefit system at this point is to enact a reasonable solution to the cash balance pension controversy.

The major portion of the defined benefit universe now takes the form of cash balance and other hybrid plans. Hundreds of sponsors have shifted from the traditional defined benefit plan as we know to this hybrid format, and the precise application of the governing statutes to these plans has been the subject of uncertainty, litigation, and now prolonged controversy.

I would suggest that the courts are not the place to resolve this issue in a coherent, rational way that takes into account all the legitimate interests in the pension system. And that Congress should step up and provide a rational, general solution to cash-balance-plan issues as soon as possible. And a solution that I would suggest is actually feasible can be done in the near term.

These types of plans have been unfairly demonized by some, and to some extent, idealized by others. There's nothing inherently wrong, of course, with the plan that is funded by the company like a defined benefit plan while stating the basic benefit as an account balance like a DC plan and providing an investment return that generally does not depend on the risks of the equity market or on employees' decisions as to how to invest.

It's the conversion, of course, from the defined benefit traditional format to the cash balance that's been the issue, and, mainly in cases where the employer has not given sufficient transition relief to provide a soft landing to older and longer-service workers contrary to many cases where the employers have, in fact, provided ample transition relief.

On the other side cash-balance plans have been characterized as the last, best, and only hope for the defined benefit system. And, in fact, I think there's some truth to that, but there's a sense in which they're not fully a part of the defined benefit system insofar as they lack one of the key attributes that makes defined benefit

plans particularly valuable, namely, the guaranteed lifetime benefit.

They're required, of course, to offer a joint survivor annuity and a life annuity, but as a practical matter, the presumptive form of payment in a cash balance is a lump sum. That's how it's presented to employees, and that's what most people, in fact, take from most cash balance plans. But cash balance plans that give a fair transition to older workers are, indeed, valuable, in particular, if they're funded by the company. So the coverage does not depend on the employee taking the initiative to decide to participate, and the investment risks and investment returns are pooled.

As a centerpiece of your action to strengthen the defined benefit system, I would suggest that you could resolve the cash balance issue in a way that does four essential things.

First, gives older workers substantial protection from the adverse effects of a conversion, including protection from wear away of the normal and early retirement benefit.

Second, allow companies that maintain cash balance plans to do so without concern that they would be treated as age discriminatory.

Third, give companies reasonable flexibility to change their plans, to make prospective amendments, including conversions to hybrid formats and to determine how to protect older workers, though not whether to protect older workers. And, finally, to resume the IRS determination letter process so these plans can get approved again and the system can move on.

In my written statement I've outlined a specific framework for solution consistent with testimony that I submitted to this Committee last summer, and while I certainly don't believe that I or anyone in particular has all the answers, I've suggested a number of very specific alternatives. And I would welcome discussion of those in this hearing or at the Committee's convenience.

On the funding side I agree with much of what my co-panelists have said. Let me just make a couple of specific points in addition. A central part of the work that needs to be done is to make the deficit reduction contribution; the accelerated funding that under funded plans are subject to to make that less volatile.

As you know, this kicks in now too late, too suddenly, and can shut off too soon. The rules also allow inappropriate funding holidays to companies when they ought to be contributing, as the Bethlehem Steel case illustrated. Bethlehem Steel also illustrates the need for better disclosure. The plan looked like it was 84 percent funded the year before it went under and turned out to be under 50 percent funded.

I agree with my colleagues that the funding disclosures need to be sensitive to the need not to panic employees or inadvertently mislead people. I think there are ways to do that. Employers should be able to fund for lump-sum distributions, even when the value of the lump sum is actuarily greater than the value of the annuity.

Chairman JOHNSON. Can you start to tie that down.

Mr. IWRY. Yes, Mr. Chairman. This is my last point.

Chairman JOHNSON. Thank you.

Mr. IWRY. And I think that that needs to change. We should allow plans to fund for the lump sum, even when it's more valuable than the annuity. Mr. Chairman, I'd be happy to answer any questions you or the members might have.

[The prepared statement of Mr. Iwry follows:]

Statement of J. Mark Iwry, Esq., Non-Resident Senior Fellow, The Brookings Institution, Washington, DC

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

Chairman Johnson, Ranking Member Andrews, and Members of the Subcommittee, I appreciate the opportunity to appear before you to discuss long-term solutions to reform and strengthen the private defined benefit pension system.[2]

This written testimony is divided into three parts. The first provides brief background on defined benefit plans, pension insurance, the PBGC, and the taxpayers' investment in the private pension system (pages 1-5 and Appendix B). The second part addresses what is perhaps the greatest single source of uncertainty currently affecting the future of the defined benefit plan system: how best to resolve the cash balance pension controversy (pages 5-21 and Appendix C). The third part of this testimony deals with defined benefit pension funding, including recent developments affecting funding and pension insurance (pages 21-25) and the often conflicting public policy objectives that need to be reconciled when formulating policy in this area (pages 25-26). This part then suggests ten specific cautions and considerations to bear in mind when considering longer-term reforms (pages 26-33). As requested on behalf of the Subcommittee, this testimony is limited to issues affecting single-employer defined benefit pension plans, as opposed to multiemployer plans.

I. Background[3]

A. Context

It is worth pausing for a moment at the outset to consider the objective of strengthening the defined benefit pension system. To be sure, defined benefit plans have important virtues as retirement programs. While not inherently superior to defined contribution plans – many of the advantages of a DB can be replicated in a different manner through an appropriately designed DC – DB plans (traditional or hybrid) tend to have favorable attributes. These include automatic employer-funded contributions (as opposed to individual salary reduction) and the ability to provide a low-cost annuity that provides lifetime payments.

For public policy purposes, however, it is worth bearing in mind that the formal distinction between defined benefit and defined contribution is not what matters most. It is more useful to examine the specific underlying attributes of a particular plan or plan design (which can be packaged together in different ways) and how they contribute to the desired outcomes. (A cash balance plan, for example, is a defined benefit plan that typically does not provide lifetime guaranteed benefits but rather lump-sum payments; on the other hand, it is funded by employer contributions, so that coverage does not depend on individual employees taking the initiative to participate.)

Accordingly, various types of plans – DBs, DCs, hybrids, 401(k)s – are all worth encouraging as a matter of policy, to the extent that they provide quality coverage that delivers retirement security to those who most need it, i.e., to the extent that they meet the basic public policy objectives of the system. (In a sense, the Social Security system comes close to the classic paradigm of a defined benefit plan that delivers quality coverage.)

Cost-effective retirement security cannot be measured merely by counting the number of plans or even the number of people covered. Instead the desired outcomes need to be measured in a more meaningful way – what amounts of benefits are ultimately delivered, how, and to whom. In a voluntary, tax-subsidized system, plans must occupy that sliver of common ground where they are sufficiently attractive and profitable to employers and other private-sector parties while delivering adequate money's worth to the taxpayers as the return on their $200 billion investment. Maximizing that common ground is often difficult, but rewarding: it helps ensure that our employer plan system – defined benefit plans as well as defined contribution plans and hybrids – continues to be vigorous and to play a central role.

B. 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 31,000 defined benefit plans that are sponsored by private-sector employers and that cover over 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 orporations that are in financial distress regarding pension plan funding and benefits in connection with corporate bankruptcy.

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[1] The witness is a Nonresident Senior Fellow at the Brookings Institution and a lawyer, as detailed in Appendix A. 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. See Appendix A.

[2] Major portions of this written statement are drawn verbatim from the witness's October 29, 2003 testimony before the full Committee, his July 2, 2003 written testimony submitted to this Subcommittee on cash balance pension plan conversions, his September 15, 2003 testimony before the Subcommittee on Financial Management, the Budget, and International Security of the U. S. Senate Committee on Governmental Affairs, and his June 4, 2003 testimony before this Subcommittee.

[3] Further context regarding the private pension system is provided in Appendix B, which is drawn nearly verbatim from my June 4, 2003 testimony before this Subcommittee.

PBGC maintains separate insurance programs for "single employer" plans and "multiemployer" plans, covering about 34.5 million and about 9.7 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. (As noted, this testimony deals with single employer plans, not multiemployer plans, which were the subject of a recent hearing of this Subcommittee.)

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.

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 in the neighborhood of $200 billion.[4] (Treasury's estimated annual tax expenditure, computed under a different method, is an amount approaching $150 billion.) Of that total, about half 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. Cash Balance Pension Conversions:
A Legislative Framework for Resolution

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. I believe that Congress can 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 and reasonable certainty regarding the applicable rules.

The following portion of this testimony illustrates a possible legislative framework for resolution of the cash balance pension issue. Of course, no resolution of this highly contentious issue would leave all parties fully satisfied. There is ultimately a sharp tradeoff between protecting older workers from certain changes in plans and preserving employers' flexibility to make changes in a private pension system where they are not required to adopt or continue plans. However,

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[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 2005, Analytical Perspectives ("FY 2005 Budget, Analytical Perspectives"). The budget documents also contain other tax expenditure estimates that are based on alternative methods.
[6] FY 2005 Budget, Analytical Perspectives.

the approach outlined here seeks to illustrate how Congress might find common ground – or at least middle ground – by allowing cash balance plans and conversions, resuming the IRS review and approval process, and giving plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. In a sense, plan sponsors have already pointed the way: corporate 'best practices" in a number of instances have sought to combine reasonable protection for employees with reasonable flexibility for the employer.

The material provided in this statement is illustrative, not prescriptive; it is intended to illustrate that Congress has realistic options for providing cash balance conversion relief with reasonable employer flexibility, rather than to make specific recommendations.

A. Preliminary Matters

The cash balance pension issue has been the subject of sharply differing views, reflected in proposed legislation, legislative and policy debate, litigation, comments on regulations, academic writing, editorials, etc. In addition, the issues relating to cash balance plans and conversions of traditional defined benefit (DB) pension plans to cash balance plans and other hybrid pension programs are relatively involved.[7]

This statement is intended only to sketch out a "broad-brush" response. It does not rehearse the legal or policy issues presented by cash balance plans and conversions; it does not go into detail regarding the specifics of the approaches outlined here; it certainly does not purport to illustrate how all of the important related issues and major questions in this area might be resolved; and, as noted, it is illustrative or descriptive rather than prescriptive. In the event that the Subcommittee wishes to have further information, I would be glad to respond.

B. Cash Balance Conversion Relief and Employer Flexibility

A central policy concern raised by cash balance plans[8] is whether and how conversions from traditional defined benefit to cash balance plans can be carried out in a manner that sufficiently protects older and long-tenured employees who would otherwise be adversely affected -- without unduly limiting employer flexibility to change their plans and without stifling innovation and creativity in the market and in pension design.[9] In fact, among the significant legal issues that have been raised regarding cash balance plans are whether the plans are inherently age discriminatory and whether conversions are age discriminatory -- particularly whether the plans or conversions violate the age-related proscriptions of section 411(b)(1)(H) of the Internal Revenue Code (IRC) and its counterpart provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA).

Plan sponsors undertaking cash balance conversions have adopted a range of provisions intended to provide varying degrees of transition protection to current employees.[10] Some of these protective provisions might be described as corporate "best practices" that are generally similar to the "choice" requirements that would be imposed by H. R. 1677, the Pension Benefits Protection Act, introduced by Congressman Bernie Sanders and this Committee's Ranking Member, Congressman George Miller, and co-sponsored by other Members. The bill requires companies that convert to cash balance plans to allow workers who are either at least 40 years old or have at least 10 years of service the choice to remain in the traditional defined benefit plan.

Other converting employers have provided protection that would not meet the standard established in H.R. 1677, but that some would describe as "good practices" that substantially exceed the requirements that would have been imposed, for example, by the regulations proposed by the Treasury Department in December 2002.[11]

C. Possible Framework for a Legislative Solution

As noted, a possible legislative resolution of the cash balance issue could allow cash balance plans and conversions, resume the IRS review and approval process, and give plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. Thus, at the core of the legislative package would be an essential quid pro quo: a clean bill of health for hybrid plans in exchange for reasonable protection of older/longer serving participants affected by conversions.

It must be recognized that this would break new ground, taking ERISA and the plan qualification rules to a place where they generally have not been before. If Congress is to give effect to a policy rooted in age discrimination concerns raised by conversions to hybrid plans, care must also be taken to minimize collateral damage to employers' willingness to sponsor defined benefit or qualified plans generally. Because of the overall state of the defined benefit system and plan

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[7] Hybrid plans, such as cash balance pension plans are plans of one type – defined benefit (DB) or defined contribution (DC) – that also have characteristics of the other type. In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

The material in this footnote is quoted essentially verbatim from prior testimony of the witness (while serving in the Treasury Department):Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, U. S. Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate, page 4. That testimony contains further discussion of cash balance plans and conversions.

[8] In the interest of avoiding further complexity, this testimony refers to "cash balance plans" rather than attempting to address the issues raised by other forms of hybrid plans such as pension equity plans.

[9] The material in this paragraph is drawn largely from my June 4, 2003 testimony, pages 5-6, 18-19.

[10] U. S. General Accounting Office, Cash Balance Plans: Implications for Retirement Income, pages 34-36 (2000).

[11] See id. Of course Congress should not view the proposed regulations as a source of potential guidance concerning the appropriate policy balance here. When it developed those regulations, Treasury was operating under a major constraint:: it was required to work within its interpretation of the current statute. As discussed below, Treasury's subsequent legislative proposal goes well beyond the scope of the proposed regulations.

sponsor fears that this type of legislation might portend further legislative restrictions on employers' flexibility to amend plans, some believe such legislation would contribute to widespread defined benefit plan freezes or terminations. However, others are concerned that the current uncertainty is likely to be more damaging, and that clear rules are needed for hybrids and conversions.

Minimizing spillover effects of the legislation would involve, among other things, distinguishing conversions to hybrid plans from other types of amendments, in order to make clear that newly-enacted participant protection requirements would apply to conversions but not to other types of amendments (or to plan terminations or freezes). Presumably, for example, the new legislation would not apply to an amendment of a traditional defined benefit plan to move from final to career average pay and/or to eliminate an early retirement subsidy in compliance with current anti-cutback requirements – unless the amendment also involves conversion to hybrid format. Legislators, regulators, or the courts would then need to consider how to deal with step transactions that involve sequential conversions and other amendments.

For these purposes, the legislation would need to define hybrid plans (perhaps in terms that refer, for example, to defined benefit plans that state the accrued benefit as an account balance) and conversions (e.g., amendment of a defined benefit plan that does not, to one that does, state the accrued benefit in terms of an account balance).

* * * * *

Explicitly or implicitly, the legislation would address hybrid plans in steady state and conversions, at least those that take place after a specified effective date. Explicitly or implicitly, it would also have to deal with past years – steady state and conversions -- or at least be drafted with care to take into account its possible implications for past years and for existing litigation.

By way of illustration, legislation could include the following 12 basic elements:

1. Provide that cash balance plans will not be treated as inherently age discriminatory, i.e., that new or steady-state cash balance plans do not per se violate the age discrimination laws if they would satisfy the defined contribution age discrimination standard of IRC section 411(b)(2).

2. As a condition of treating a conversion as lawful, require the plan to protect a specified class of older and longer-service workers from wearaway of their normal and early retirement benefits.

3. As a further condition, require the plan to give that protected class of older and longer-service participants a reasonable level of additional protection from the adverse effects of the conversion.

4. Prescribe the minimum level of protection in a manner that maximizes employers' flexibility to choose among a specified array of "safe harbor" alternatives for designing their protective arrangements (discussed below).

5. Give employers further flexibility by providing a "safety valve", allowing individual plan sponsors to demonstrate to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors. This could include a "facts and circumstances" demonstration.

6. Give IRS specified additional FTE and budgetary resources to help it address the cash balance backlog, provided Treasury and IRS concur. A conversion that is the subject of such a safety valve application (see #4, above) could not be implemented before IRS had received such additional FTEs and funds or without an IRS determination letter. IRS would be authorized to prescribe reasonable conditions to limit the volume of such case-by-case applications.

7. Direct Treasury to propose, after consultation with EEOC and DOL, regulations implementing the safe harbors and related legislation (replacing the December 2002 proposed regulations) and to resume the IRS determination letter review process for cash balance conversions.

8. Possibly authorize Treasury to publish additional safe harbors that are not less protective of older or longer-service participants than the statutorily described safe harbors and that would not go into effect until after a longer than usual period following their submission to Congress in proposed form.

9. Allow cash balance plans to pay lump-sum distributions of the participant's account balance, subject to possible limitations of interest crediting rates so as not to exceed market rates of return (sometimes referred to as the "whipsaw" issue).

10. To the extent practical, take steps to clarify the application of other related plan qualification provisions to hybrid plans and direct Treasury to fine tune the safe harbors to the extent necessary to coordinate conversion protections for older workers with other plan qualification rules, including the prohibitions on discrimination in favor of highly compensated employees and restrictions on "backloading" of benefits.

11. Provide that the legislation is intended to have no effect on the application or interpretation of the age discrimination laws beyond the limited sphere of hybrid pension plans and conversions.

12. Congress must determine the effective date of the provisions referred to in ## 2-4, above, and whether a reasonable "safe harbor" (involving a lower level of participant protection) should apply to past conversions (including those for which an application for IRS determination letter has been pending) and whether plan sponsors that wish to "top up" their past conversions to meet such a standard should be given specific methods of doing so.

D. Building Blocks for Constructing Conversion Safe Harbors

1. In General

In considering how to design options that employers can use to protect current employees affected by a conversion, it is important to bear in mind that employer flexibility to choose among a menu of alternatives means that, in many instances, the protection will be only as strong as the weakest alternative. In accordance with the character of this discussion as descriptive rather than prescriptive, this testimony is not intended to advocate or recommend a particular approach regarding the degree or specific nature of the conversion protection Congress should require. Determining how much protection to require for current employees from the potential adverse effects of a conversion depends on how the nature

and gravity of those effects are viewed and on how employees' interests in protecting their benefits are balanced against plan sponsors' need for flexibility and the potential impact on their willingness to maintain plans.[12]

2. Full Protection of Benefit "Expectations"

According to one view, the law should protect older workers' expectations of future higher benefits under a traditional DB plan from the effects of a conversion – as some employers have done – because older workers affected by the conversion have given up current wages (whether implicitly or explicitly) in exchange for a traditional pension formula that provides only modest benefits in the employee's earlier years on the understanding that longer-serving employees will be more richly rewarded late in their career. In addition, under a related view, conversions often discriminate against older workers, treating them less favorably than younger employees. These concerns might suggest requiring older or longer-service employees to be grandfathered in the old formula benefit, giving them the greater of the old and new formula benefit, or giving them a choice between the two formulas at retirement.[13] See, for example, H.R. 1677.

Some employers have extended such grandfathering, "greater of" treatment, or choice to a specified class of individuals who participated in the traditional DB plan at conversion (e.g., those who have reached a certain age and/or have completed a certain period of service as of the conversion). Variations of this view – reflected in various other corporate practices and in Treasury's legislative proposal, discussed below -- would require such protection to last only for a limited period of years.

Under these approaches, it is assumed that where the conversion is intended to reduce pension costs for the plan sponsor or to spread the benefits of the DB plan more broadly among the work force, the temporary transition relief for current employees will not prevent the sponsor from realizing those benefits in the long run, as the number of nongrandfathered employees grows while the number of grandfathered employees diminishes.

3. Preventing the Worst of Both Worlds

A different view is driven more by a recognition of the employer's ability to freeze or terminate a DB plan, even a traditional one with a "backloaded" pattern of benefits, and by a concern about the impact on the private employer-sponsored pension system of beginning to require qualified plan sponsors to protect employee expectations of future benefit accruals. For some, however, this concern is tempered by a recognition that a conversion can result in a smaller total benefit for an employee than if he or she had been covered by the cash balance plan for the employee's entire career. This can occur because, during the early years of one's career, the traditional DB might provide smaller benefits than the cash balance plan. (This is sometimes referred to as the "bow tie" effect, reflecting of the shape of the graph depicting it.)

Thus, some would hold that even if it were impractical for the system to require converting employers to guarantee their workers the best of both worlds (the greater of the old and new formulas or a choice between them), it should at least require employers to protect their employees from the worst of both worlds. One method of preventing the "bow tie" effect is to establish an opening account balance equal to the present value of a hypothetically "reconstructed" cash balance benefit. This would be the benefit the employee would have earned before the conversion date had the cash balance formula covered the employee since he or she began work with the employer (assuming that amount exceeds the present value of the employee's actual pre-conversion accrued benefit under the traditional DB plan). Alternatively, if the "sum-of" (A+B) method (discussed below) is used, and if the present value of the A piece (the frozen old-formula benefit) is less than the hypothetically reconstructed preconversion cash balance benefit, then the present value of the A element might be increased to equal that reconstructed benefit.

4. Preventing Wearaway

"Greater-of" Approach. A related adverse effect of a conversion on employees is the extended suspension of new benefit accruals that can occur after a conversion when employees are promised the greater of an old-formula benefit that is frozen (because additional service is not earning employees additional benefits under that formula) and a new-formula benefit that is less generous but that does continue to grow with additional service. This so-called "wearaway" of the frozen old-formula benefit – whereby no new net benefits are being earned so long as the frozen old-formula benefit continues to exceed the growing new-formula benefit – can apply to the normal retirement benefit (typically the benefit payable at age 65) and to the early retirement benefit. In many cases, where the early retirement benefit is "subsidized" and hence is actuarially more valuable than the normal retirement benefit, the wearaway of the early retirement benefit will be potentially more costly to the employee than the wearaway of the normal retirement benefit.

Some would advocate requiring protection only to the extent necessary to prevent or to simply mitigate the wearaway – of either the normal and early retirement benefits or only the normal retirement benefit. (The December 2002 proposed Treasury regulations would require converting plan sponsors to take steps to mitigate the wearaway of the normal retirement benefit, but the Treasury's later legislative proposal would prohibit wearaway of the early retirement benefit as well.)

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[12] The discussion in this part does not address concerns that have been raised to the effect that the basic structure of the cash balance plan formula generally fails to comply with the existing provisions of IRC section 411(b)(1)(H) and similar ADEA and ERISA prohibitions on reduction in the rate of benefit accrual because of the attainment of any age. To the extent that concerns such as these are viewed as more in the nature of legal concerns under the current statutory provisions than policy concerns, they could be addressed as part of a legislative package, such as that outlined here, that would protect older workers from the adverse effects of cash balance conversions. At the same time, such concerns can also reflect an underlying policy concern about the effects of cash balance plans and of legislation that might encourage them. This testimony does not attempt to address the debate regarding the policy merits and drawbacks of hybrid plans.

[13] Some contend that employee choice regarding such technical matters is less appropriate than grandfathering employees in the old formula to the extent it would provide a greater benefit at retirement. Under this view, permitting employees a choice at retirement amounts to little more than offering a choice between more money and less -- an exercise that is either wasted motion or, in a few cases, unnecessarily risky. And offering employees a choice at the time of conversion presents an undue risk of unwise or uninformed choices, which can ultimately result in remorse and litigation to the detriment of both employees and employers. In view of the risk of eventual litigation, the concern has been expressed that choice at conversion puts excessive pressure on the accuracy, comprehensiveness, and usefulness of the plan sponsor's disclosures and any related assistance to employees. Choice also raises issues relating to the handling of plan amendments that take effect between conversion and retirement.

"Sum-of" or "A+B" Approach. This approach would formulate protections based generally on a policy that employers should continue to be free in the future to stop one plan formula and start another, but without offsetting the old benefits against the new – at least not in a way that particularly disadvantages older workers. Thus, the employer could be required to mimic the result that would obtain if it froze the traditional DB plan and adopted a new cash balance plan that provided benefits wholly unrelated to the old frozen plan benefits.

This would suggest a 'sum-of' or "A+B" approach whereby employees' normal and early retirement benefits after the conversion are equal to the sum of the normal or early retirement benefits they earned before the conversion under the old plan formula (the "A" element) and the cash balance benefits they earn after the conversion (the "B" element). (This "sum-of" approach is contrasted with the "greater-of" approach described above, which promises employees the greater of an old-formula frozen benefit and a growing new-formula cash balance benefit.)

Recognizing Post-Conversion Compensation Increases. A variation would require the employer to increase the "A" element – the benefit earned under the old formula before conversion – to reflect post-conversion increases in compensation (though not post-conversion service). The rationale would be that, even if the employee is not grandfathered in the entire old formula such that it would continue to apply to service after the conversion, the final average pay feature of the old formula was a particularly key element of the employee's expectations that should be honored after the conversion. In addition, essentially indexing the pre-conversion benefit for inflation in this manner can help address the concern of those who believe that merely preventing post-conversion wearaway does too little to offset the harm to older employees.

Immediate Vesting. Another possible element would be to require full and immediate vesting of benefits (to the extent funded) upon the conversion. The rationale for this would be that the conversion, if likened to a freeze of one plan and establishment of another, has an effect similar to a partial termination of a plan that would require immediate vesting.[14]

Establishing Opening Account Balance to Prevent Wearaway of Normal Benefit. A variation on the "sum-of" approach would allow the employer, as an alternative, to establish an opening account balance under the cash balance formula that includes the full present value of the normal retirement benefit the employee had earned under the traditional plan formula before the conversion, and that grows as the employee earns cash balance pay and interest credits. Congress could require the present value to be calculated using actuarial assumptions that include the statutorily prescribed interest rate for determining present values of pension benefits. The advantage of this alternative to the "sum-of" is presentational simplicity: it presents the full normal retirement benefit, pre- and post-conversion, in a single format, as an account balance.

A major drawback, however, is that the opening account balance approach does not readily lend itself to preventing wearaway of early retirement benefits. (It also does not readily lend itself to recognizing the effect of post-conversion compensation increases on the traditional old-formula benefit.) Early retirement benefits under a traditional DB plan can be particularly valuable because they often are "subsidized" relative to the normal retirement benefit (i.e, the monthly or annual payment under the early retirement annuity is not reduced – or not reduced sufficiently -- to reflect the fact that it begins earlier and therefore is expected to make more payments than the age-65 annuity). Consequently, the opening account balance method needs to be supplemented by a contingent early retirement subsidy (the "pop-up" benefit described below).

"Pop-Up" Early Retirement Subsidy. An early retirement subsidy is a contingent benefit. Its value depends on whether and when the employee retires. An employee does not realize any early retirement subsidy if he or she terminates employment either before becoming eligible for it or after reaching normal retirement age. Consequently, the value of the subsidy is not readily captured in a post-conversion opening account balance. Attempts to do so, depending on how they are designed, tend to result in age discrimination, partial loss of benefits, and windfalls.

However, early retirement subsidies can be preserved on a contingent, "springing" basis. The plan keeps track of the subsidy under the old formula and prevents wearaway of the subsidy by adding it to the employee's total retirement benefit (under the old and new formulas) if and when the employee retires early and qualifies for it. This "pop-up" protection can be quite important to employees, although employers note that it comes at a cost in terms of presentational simplicity. It can also be combined with the use of an opening account balance that reflects the present value of the normal retirement benefit earned before the conversion.

5. Greater of "Sum-of" and "Greater-of"

Another variation would provide a normal retirement benefit equal to the greater of the benefit produced by the "sum-of" A+B method and the "greater-of" (opening account balance) method. As noted,

- the "sum-of" method provides a total benefit equal to the sum of the frozen old formula pre-conversion benefit in the form expressed under the traditional plan ("A") and the new formula account balance resulting from annual post-conversion cash balance pay and interest credits ("B");
- the "greater-of" method provides a total benefit equal to the greater of the old formula frozen benefit and the new formula account balance, which in turn consists of an opening account balance equal to the present value of the pre-conversion benefit plus annual post-conversion cash balance pay and interest credits.

This approach would prevent wearaway without the associated risk, under some circumstances, that the final benefit will be less than it would be under a "greater-of" approach.

6. "Straight-lining": Preventing Reduction of the Pre-Conversion Accrual Rate

Another view would stop short of requiring protection of employees' expectations of steadily increasing accrual rates under the traditional defined benefit plan, but would interpret the section 411(b)(1)(H) prohibition on reducing the rate of

[14] Some have argued that conversions should be treated as plan terminations, triggering not only immediate vesting but also annuitization and excise and income tax on any surplus assets.

benefit accrual because of age as requiring a comparison of older and younger employees' rates of benefit accrual before and after the conversion. Instead of comparing a conversion to a freeze of one plan and fresh-start adoption of another, this approach would take the view that because the conversion is a plan amendment and the plan retains its defined benefit character, the conversion should be analyzed as a plan amendment under IRC section 411(b)(1)(H) to determine whether it reduces the rate of benefit accrual because of age.

To permit an "apples to apples" comparison for this purpose, one could take the present value of the traditional DB plan's pre-conversion rate of accrual and express it as an equivalent allocation rate (i.e., an equivalent DC plan contribution) or cash balance pay credit.

- For example, a conversion might provide a 5%-of-pay hypothetical cash balance contribution or pay credit to all employees, including an older employee who had an accrual rate under the traditional DB plan equivalent to a 12%-of-pay contribution and a younger employee who had an accrual rate under the traditional plan equivalent to a 4%-of-pay contribution.

Under one view, the conversion would have impermissibly reduced the rate of benefit accrual on account of age. Under such an interpretation, preventing age discrimination would not require grandfathering an older employee in his or her traditional DB benefit formula, including expected future increases in the rate of benefit accrual, but only in a pay credit equivalent to the employee's pre-conversion rate of benefit accrual. Literal adoption of such an approach would give rise to a host of issues, such as the practical complexity of maintaining many different age-sensitive pay credit rates and coordination with qualified plan standards designed to prevent discrimination in favor of highly paid employees. One alternative, however, would be to view this concept not as an application of current law but rather as an underlying theory that might serve as a basis for designing a safe harbor, available for future conversions, that would involve age- or service-weighted pay credits (as described in the following section).

7. Age- or Service-Weighted Pay Credits or Opening Balances

A practice not uncommon among converting employers has been to provide for a tiered pay credit rate under the cash balance plan – a higher pay credit percentage for older (or longer service) employees than for younger (or shorter service) employees – though not necessarily as high as would be needed to equal the older worker's pre-conversion rate of accrual (see 6, above).

Congress could, if it wished, borrow a leaf from these employers. A conversion could be treated as not age discriminatory if older employees receive sufficiently high and durable cash balance pay credits – defined by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Like other ameliorative measures, such an approach would need to be carefully crafted to avoid doing violence to age discrimination law generally. It also would need to be coordinated with qualified plan nondiscrimination policy and standards.

Additional amounts credited to older employees' opening account balances might be designated as another permissible means of offsetting the adverse effects of the conversion, if meaningful equivalencies can be determined. It is difficult, however, to preserve the benefits of an early retirement subsidy solely through higher pay credits or an additional opening account balance, as opposed to an additional benefit that becomes payable if and when a participant becomes eligible for the early retirement subsidy after retiring (the "pop-up" approach).

E. Conversion Safe Harbors

As noted earlier, Congress could prescribe minimum standards for protecting employees from the adverse effects of cash balance conversions by giving employers flexibility to choose among a specified array of "safe harbor" alternatives for designing protective arrangements.

In addition to defining safe harbors (which could be fleshed out through regulations once they were sufficiently described in the statute), Congress would need to determine how non-safe-harbor conversions would be treated. For example, one possible approach would be to provide that a conversion that does not satisfy any safe harbor is vulnerable to challenge as age discriminatory (i.e., it reduces the rate of benefit accrual on account of age in violation of the statutory provisions) and is not entitled to an IRS determination letter covering the age discrimination issue, unless the specific facts demonstrate otherwise. Another approach would be to provide that such a conversion is subject to a rebuttable presumption that it reduces the rate of benefit accrual because of age.

As noted, this testimony is not intended to suggest where Congress should set the bar, i.e., it does not advocate or recommend a particular approach regarding the amount or type of conversion protection Congress should require.

Conversion safe harbors could be constructed from the methods or "building blocks" described above. By way of illustration, possible safe harbors might include provisions along the lines of the following:

1. Full Protection of "Expected" Benefits. One safe harbor could require protection of older or longer-service employees' old-formula benefit expectations, including expectations regarding future increases in the rate of benefit accrual. This protection could take the form of being (a) grandfathered in the old formula benefit, (b) given the greater of the old and new formula benefit at retirement, or (c) given a choice between the two formulas at retirement. See D.2, above.

- In addition to limiting the required protection to a particular class of employees by age and service, Congress could, if it thought it appropriate, limit the duration of the required protection.

2. Preservation of Pre-Conversion Rate of Accrual. A second safe harbor might treat a conversion as not reducing the rate of benefit accrual because of age if the plan provided age-weighted (or age- and service-weighted) pay credits based on the pay credit equivalents of employees' pre-conversion rates of benefit accrual. See D.7, above.

- If Congress thought it appropriate, it could set the bar for age-weighted pay credits somewhat lower than – but taking into account -- the level required to make employees whole relative to their pre-conversion accrual rates. The legislation could, for example, define the level of credits required for older employees by reference to the pre-

conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Congress might also allow other types of credits – such as one-time transition credits added to the opening account balance -- to substitute for some or all of the higher pay credits, although the determination of rough equivalencies would not be straightforward. See D.7, above.

3. "Sum-of" (A+B) Plus Early Retirement Subsidy Pop-Up and Compensation Updates to Old-Formula Benefit. A third safe harbor might be constructed by building on the anti-wearaway protections described in D.4, above. Just as Congress, if it decided to seek a middle ground between competing interests, would have to determine how much to limit or subtract from the basic structure of the first two safe harbors (full grandfathering), it would similarly have to decide how much to build up or add to the basic structure of this third safe harbor (the "sum-of" approach to preventing wearaway).

Often, the two aspects of the traditional DB benefit formula that contribute most to the "backloaded" character of the plan are early retirement subsidies and the final average pay feature. If it wished to, Congress could partially offset the loss of these features by, for example, designing a safe harbor that begins with the "sum-of" (A+B) method and adds both an early retirement subsidy pop-up and recognition of post-conversion compensation increases in determining the value of the "A" element (the frozen old-formula benefit). See D.4, above.

4. Enhanced Opening Account Balance Plus Early Retirement Subsidy Pop-Up. As an alternative to the "sum-of" approach, which starts with a zero account balance after the conversion, another safe harbor could permit use of the opening account balance method outlined in D.4, above. Under that method, the cash balance account begins by including the full present value (determined using the statutory interest rate) of the employee's pre-conversion normal retirement benefit, and grows as the employee earns cash balance pay and interest credits.

As in the previous safe harbor, early retirement subsidies under the traditional plan would be preserved via an early retirement subsidy pop-up. However, since this single account balance (opening account balance) method does not readily accommodate recognition of post-conversion compensation increases in determining benefits, the employer might be required to increase the opening account balance by a specified percentage as a rough-justice substitute.

5. Safety Valve Facts and Circumstances Determination. As an alternative to using a safe harbor method, employers might be given further flexibility through a "safety valve" procedure allowing individual employers to make a "facts and circumstances" demonstration to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors or that, in any event, their conversion does not reduce the rate of benefit accrual because of age in violation of IRC section 411(b)(1)(H).

Any such safety valve option would likely impose heavy demands on IRS resources. Processing such an application would be a labor-intensive procedure requiring highly trained technical personnel, who are in short supply. Accordingly, access to such a determination would need to be, in effect, rationed. This could be done by appropriately limiting the eligibility conditions. In addition, a natural rationing process might occur as plan sponsors seeking such special determinations instead of complying with one of the safe harbors would be forced to wait in the queue and probably endure substantial delays. Of course such rationing would be justifiable only if the safe harbors were reasonable.

* * * * *

As an additional cross-cutting requirement, converting employers, regardless of which safe harbor they are relying on, might be required to protect employees from the "worst of both worlds" situation described in D.3, above, using the "reconstructed account balance" described there or an alternative method.

* * * * *

F. Treasury's Legislative Proposal

In response to a congressional directive, the Treasury Department suspended its cash balance regulations project and, in February 2004, issued a legislative proposal regarding cash balance conversions. Substantial elements of the Treasury proposal (summarized in Appendix C to this testimony) are similar to elements outlined above and in my July 1, 2003 written statement submitted to the Subcommittee.

In my view, the Treasury proposal represents a serious and constructive first step toward a solution. Congress should carefully consider a number of the elements in Treasury's proposal when it crafts legislation. However, the Treasury proposal as a whole should not be viewed as meeting the requirements of an adequate solution, for reasons summarized in Appendix C.

G. Dealing With Past Conversions

As noted, the process of crafting such legislation also requires dealing – explicitly or implicitly – with past years, including conversions that occurred in the past. Any bill would need to be drafted with care to take into account its possible implications for past years and for existing litigation. A number of alternative approaches are possible, including --

1. Statutory silence regarding past conversions with no inference language in the legislative history.

2. Required protections for past conversions (significantly lower than those required for future conversions) as a condition of obtaining comfort regarding past steady state hybrids or a safe harbor for past conversions that does not impose an explicit requirement.

3. Some kind of process for obtaining comfort and resolving disputes regarding past conversions.

Plan sponsors that undertook conversions in the past would ideally wish for an explicit clean bill of health for past conversions. But if this is not feasible, then, according to one point of view, legislation should establish a prospective

effective date for conversion requirements and "no inference" language regarding past conversions.[15] According to this view, plan sponsors are better off without any statutory provisions seeking to provide "comfort" for past years: a safe harbor for past conversions arguably invites plaintiffs to challenge all conversions failing to meet the safe harbor. The variety of transition provisions in past conversions means many might not satisfy any single or simple safe harbor.

Under a second and different view, at least some cash balance plan sponsors would welcome the certainty of being able to obtain comfort that their past conversions will not be challenged in court and that their hybrid plan will not be treated as age discriminatory in its steady state for past as well as future years. Under this approach, a statute that prescribes specific requirements for future conversions but provides only a reasonable and significantly lower safe harbor standard for past conversions would not mean that past conversions failing to meet the safe harbor are necessarily age discriminatory or otherwise violate the plan qualification requirements. (The safe harbor would prescribe one method -- but not the only method[16] -- of demonstrating that the conversion was not age discriminatory.) But such legislation would give comfort to employers whose past conversions met the safe harbor and would give a choice to employers that want protection to top up and meet the safe harbor retroactively

Finally, others would argue that, just as the price of an explicit statutory blessing of future steady state hybrid plans might be adequate protection of older participants in future conversions, the price of any statutory protection of employers from litigation over steady state hybrids in past years should be at least some protection of older workers in past conversions. Plan sponsors whose past conversions failed to meet this lower bar (presumably in the form of a safe harbor) would be able to "top up" after the fact, at least with respect to affected older employees who are still active, and would have guidance on how much top up is necessary on a safe harbor basis. According to this view, the employees who are most aggrieved are those adversely affected by the many past conversions – at least those that did not provide adequate transition relief – and because many of these employees have yet to retire, their benefits have not yet been definitively calculated.

* * *

A number of the potential arrangements described here can be viewed as means of giving employees "half a loaf" – although the exact fraction that is or should be provided is the subject of vigorous debate. If Congress wished to find middle ground on this issue that strikes a balance between the legitimate competing interests, these are tools it can use (in addition to other techniques not described here). As noted, however, it is not the purpose of this discussion to suggest where Congress should strike any such balance along the spectrum of possible requirements from fuller protection (as in H.R. 1677) to far more limited protection.

In addition, this discussion does not attempt to be comprehensive. It does not address many of the other issues implicated by or relevant to a legislative approach to conversions (other rules governing cash balance plans, application of a legislative approach to other hybrid plans, coordination with rules prohibiting discrimination in favor of highly compensated employees and restricting backloading, sanctions, financial accounting issues, etc.[17]).

* * * * *

III. Reforms Relating to Pension Funding and Pension Insurance

A. Recent Developments

1. Increased Underfunding and PBGC Deficit

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 by the end of FY 2002 and $11.2 billion by the end of FY 2003. In FY 2003, the PBGC paid benefits (and administrative costs) worth $2.5 billion (nearly $1 billion more than those paid in FY 2002), while collecting nearly $1 billion in premiums. Overall, PBGC's assets of $34 billion indicate that it has the wherewithal to continue meeting its obligations for some years to come.

PBGC's financial condition could alternatively be expressed in percent funded terms, taking PBGC's assets as a percentage of its liabilities, in a manner somewhat analogous to the ratios used to assess the funding status of the pension plans PBGC guarantees. At the end of FY 2003, the ratio of PBGC's reported $34 billion in assets to its reported $45.3 billion in liabilities was 75%. This represented a decline from 87.6% at the end of FY 2002, although the PBGC's net loss has diminished in the past year, from $11.4 billion in FY 2002 to $ 7.6 billion in FY 2003. (Losses from plan terminations declined by about $4 billion between FY 2002 and FY 2003.)[18] However, PBGC's funded percentage, like

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[15] Many argue that, when converting in the past, employers had no way of knowing that any particular standard would apply; that they read signals from the government (e.g., section 401(a)(4) regulation safe harbor provision and preamble sentence, Notice 96-8 and, arguably, section 204(h) notice advance disclosure legislation) stating, suggesting or implying, as the case may be, that steady state cash balance plans were not age discriminatory, and numerous cash balance plans received IRS determination letters following conversion. Others respond that cash balance plans by their nature violated the literal terms of the three statutes; that conversions that failed to protect older participants were age discriminatory, and that at least some employers and their advisers were aware, while others arguably should have been aware, of this possibility.

[16] A possible alternative approach might: allow controversies over past conversions to be resolved through a process established by legislation. The process might involve alternative dispute resolution without a government role or, alternatively, it might be a governmental process such as the opportunity to apply for an IRS determination that a past conversion (with or without top-up) satisfied a standard designed to prohibit age discrimination.

[17] Some have argued, for example, that future legislation should not permit conversions to cash balance plans that are "integrated" with Social Security (i.e., that use a formula that takes advantage of "permitted disparity" referred to in IRC section 401(l) to provide a higher pay credit for compensation above than for compensation below a specified level) on the theory that this plan design is inconsistent with the rationale for hybrid plans to the effect that they are easy for participants to understand.

[18] PBGC 2003 Annual Report.

any assessment of its financial condition, is highly sensitive to the judgments made as to the probability of future liabilities and assets, including PBGC's estimates of the total assets it can expect to recover if and when "probable" future claims materialize.

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 -- have contributed dramatically to the underfunding problem. Of the $7.6 net loss for FY 2003, a large portion was caused by pension plan terminations (actual and probable) and another large (though slightly smaller) portion was attributable to increased liabilities due to lower interest rates.

According to PBGC estimates in 2003, its losses might ultimately include an additional $83 to $85 billion of unfunded vested benefits that the agency would be required to take over if certain plans maintained by financially weak employers were to terminate.[19] It is hard to quantify such exposure with much confidence because the results could vary widely depending on the financial condition of a small number of companies in a few industries. However, based on last year's estimates, the General Accounting Office in 2003 placed PBGC's single-employer insurance program on its high-risk list of federal agencies with significant vulnerabilities.

To help put the amounts into perspective, the total amount of defined benefit pension benefits PBGC insures is approximately $1.5 trillion, and PBGC has estimated that total underfunding in the single-employer defined benefit system amounts to more than $350 billion. (Before 2001, the previous high water mark in underfunding had been little more than one fourth of that amount, in 1993.) Of the $350 billion, the $83-$85 billion figure cited earlier represents estimated underfunding in plans sponsored by financially troubled companies (where PBGC estimates that plan termination is "reasonably possible"). However, it should be emphasized that this is a "soft" estimate, which, like PBGC's financial condition generally, is quite uncertain because, as noted, it is highly sensitive to the risk of a few large bankruptcies.

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 a large portion 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.[20] For example, in 2002, PBGC involuntarily terminated a plan of Bethlehem Steel Corporation that had total underfunding of about $4.3 billion. (PBGC indicates that, in the plan sponsor's last filing before termination, the sponsor reported that the plan was 84% funded on a "current liability" basis, but upon termination the plan proved to be only 45% funded on a "termination basis.")

2. Recently Enacted Short-Term Legislative Solution

On April 10, 2004, the President signed into law H.R. 3108 (originally sponsored by Chairman Boehner and cosponsored by Subcommittee Chairman Johnson and Committee Ranking Member Miller), the Pension Funding Equity Act. This legislation provided short-term funding relief to the sponsors of defined benefit plans by replacing the 30-year Treasury bond discount rate for determining pension liabilities with a higher corporate bond rate, thus reducing the present value of liabilities. The new rate applies through 2005.

The Act also reduces the special accelerated funding requirements (the "deficit reduction contribution" or "DRC") imposed on significantly underfunded plans as a result of the 1987 and 1994 pension funding reforms -- but the Act limits this relief to airline and steel company plans. The legislation reduces the DRC for those plans by 80 percent for the next two years. The statute gives special funding relief to certain multiemployer plans as well.

3. Other Fundamental Trends

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.[21] 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 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

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[19] PBGC Annual Report for 2003, page 19.

[20] Most of the financial data in this testimony regarding PBGC and its exposure are from PBGC's 2003 annual report . Some of the data 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.

[21] See, e.g., PBGC Annual Report for 2003, page 6.

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. 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.[22] 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.

B. 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".

Balancing these objectives is exceedingly difficult. However, the system needs to transition from temporary funding relief 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.

C. Specific Cautions and Considerations

The major statutory pension funding reforms of 1986, 1987 and 1994 have left the defined benefit 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.

1. Avoid Penalizing Plan Sponsors That Are Funding Adequately

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[22] 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 Subcommittee, June 4, 2003, as well as the testimony of other witnesses presented at a hearing of the Subcommittee on that date.

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.[23]

2. Assist Plan Sponsors to Protect Themselves from Funding Volatility and Reconsider De Novo the Appropriate Permanent Funding Discount Rate

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 recent circumstances that necessitated the short-term funding relief Congress has just enacted have made the task 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 goes too deep or lasts too long, it puts off the day of reckoning, and can cause greater volatility when it expires. This can make it harder to strengthen long-term pension funding in a gradual manner that minimizes volatility and enables plan sponsors to engage in appropriate advance budgeting.

Congress should not view the recently enacted two-year funding interest rate relief as having permanently or presumptively laid to rest the issue of the appropriate long-term funding discount rate. Congress should now take up that issue de novo, balancing all of the considerations that are relevant to a long-term determination, including the need for adequate long-term funding to protect participants' benefits and the potential effects on employer willingness to sponsor defined benefit plans.

3. 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"[24] (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.

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.[25]

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.

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

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[23] 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. The Administration has indicated that it is therefore 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. Any such approach would raise significant concerns for plan sponsors.

[24] 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.

[25] 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.

The Administration has put forward several proposals to address the "moral hazard" associated with the current system of pension funding. As stated in Administration 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."[26] 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.[27] 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. 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.

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[26] Combs testimony, pages 6-7.

[27] 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.

5. Allow Plan Sponsors to Fund Taking 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.

6. Beware of Unduly Restricting the Size of Benefit Payments (Including Single Sums) in the Name 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 permanent funding relief 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, the discount rate prescribed for funding 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.

7. Arrange for Congressional Access to Relevant Data and to Modeling

It is worth recalling 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 considers comprehensive, permanent reform, it needs the active cooperation of the Executive Branch to give it access to the best available data, analysis and modeling. Transparency of analysis – sharing of data and modeling capability by the PBGC, the plan sponsor community, their professional advisers, and others – is a necessary condition of responsible policymaking with respect to pension funding. Of course, the process must carefully protect proprietary and other confidential or sensitive information specific to individual employers, including taxpayer confidential information.

8. Beware of Measures That Could Jeopardize Long-Term Fiscal Responsibility

Legislative measures that would enhance retirement security may entail significant revenue costs. If paid for through appropriate offsets, such legislation can of course represent an entirely justifiable expenditure of tax dollars. However, particularly in view of the current federal budget deficit, certain kinds of proposals involving revenue costs should be viewed with particular skepticism. These are proposals to change the expected tax treatment of current pension accumulations by exempting a portion of those accumulations from taxation in the name of encouraging annuitization or for other reasons.

While encouraging lifetime guaranteed benefits is important -- and in fact is one of the main reasons for supporting the defined benefit system -- proposals to exempt from taxation otherwise taxable distributions of current pension balances present serious issues of fiscal responsibility. Trillions of dollars of benefits have accumulated with the aid of tax-favored contributions and tax-deferred earnings, with the understanding that they would be taxed upon distribution. In the long term, responsible federal budget policy is dependent on income tax revenues from these benefits accumulated in defined benefit and defined contribution plans. The "slippery slope" potential of measures that would exempt a portion of these accumulations from tax should not be underestimated.

9. Be Wary 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.

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

The regulation of cash balance and other hybrid plans has important consequences for the future of the defined benefit system and for workers' retirement security. As discussed at length earlier in this testimony, I believe that Congress can and should resolve the cash balance issue in a manner that provides substantial protection to older workers affected by conversions while allowing employers reasonable flexibility to change their plans and reasonable certainty regarding the applicable rules.

* * * * *

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

Appendix A

Biographical Information

The following biographical information is provided at the Subcommittee's request:

J. Mark Iwry served from 1995 to 2001 as the Benefits Tax Counsel at the U.S. Department of the Treasury. During that time, he was the principal Executive Branch official responsible for tax policy and regulation relating to the Nation's tax-qualified pension and 401(k) plans and other employee benefits. He is currently a nonresident Senior Fellow at the Brookings Institution and practices law with the firm of Sullivan & Cromwell, specializing in pensions, executive compensation, health care and other employee benefits. Mr. Iwry's testimony before this subcommittee reflects only his individual views. The views expressed in his testimony are his personal views only. Those views should not be attributed to the staff, officers, or trustees of the Brookings Institution or to Sullivan & Cromwell or any client of that firm.

Mr. Iwry has testified before various congressional committees – both on behalf of the Executive Branch and the Treasury Department and, since leaving government, as an independent expert – and has previously been a partner in the law firm of Covington & Burling, has chaired the Employee Benefits Committee of the D.C. Bar, has co-authored a volume on 401(k) plans, and has spoken before more than 200 professional, industry and other groups in the US and abroad.

While in government, he was widely recognized for his work with the business, financial, professional and nonprofit communities to expand coverage while simplifying and rationalizing pension and benefits law. In 2001 he received the Secretary of the Treasury's Exceptional Service Award "[i]n recognition of his outstanding leadership and accomplishments ....Widely respected as Treasury's benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests... His technical acumen and leadership have garnered praise from colleagues within Treasury, the IRS, the Congress, and the employee benefits community at large."

Mr. Iwry played a central role in developing the Saver's Credit to expand 401(k) and IRA coverage of moderate- and lower-income workers (claimed last year on over 3 million tax returns) and the "SIMPLE" 401(k)-type plan for small businesses (now covering an estimated 2 million workers). He also has initiated or orchestrated numerous other significant improvements and simplifications of the Nation's pension system and benefits law and regulation, such as approval and expansion of automatic enrollment in 401(k) and 403(b) plans, the automatic rollover IRA to curtail pension leakage, repeal of the complex section 415(e) combined limit on pension benefits, simplification and liberalization of IRA and employer plan minimum distribution rules, new incentives for immediate 401(k) participation, and development of workable rules for pension portability, anticutback relief, 401(k) safe harbor plans, same desk rule and other benefits in corporate transactions, electronic plan administration, new comparability, COBRA, health care portability, Social Security taxation of deferred compensation, and cafeteria/flexible benefit plans.

Mr. Iwry received a special award from the IRS (Office of Chief Counsel) in 2001 "[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation's tax system." He has regularly advised Members of Congress and congressional staff on both sides of the aisle, and his views are frequently reported in the Wall Street Journal, New York Times, Washington Post, and other major media and trade press.

Mr. Iwry is an honors graduate of Harvard College and Harvard Law School, and has a Master of Public Policy degree from Harvard's Kennedy School of Government.

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Appendix B

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[28].

[28] 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

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.[29] 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.[30] When they are covered, they are likely to have disproportionately 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.[31] 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.[32] 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?"[33]

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 (or tax deduction) for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings. Roughly three out of four American households are in the 15%, 10% or zero income tax brackets. (Refundable tax credits would help address this problem, as would even nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions (and voluntary employee contributions to defined benefit plans) under section 25B of the Internal Revenue Code.)

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.

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.

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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").

[29] 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").

[30] 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 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").

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

[32] See Engen and Gale (2000).

[33] March 23, 1999 Testimony, pages 3-4.

Appendix C

Treasury's Legislative Cash Balance Proposal

A. Basic Elements

In response to a congressional directive, the Treasury Department suspended work on cash balance regulations and, on February 2, 2004, issued a legislative proposal regarding cash balance conversions. Substantial elements of the Treasury proposal are similar to elements outlined above and in my July 1, 2003 written statement submitted to the Subcommittee. In my view, the Treasury proposal represents a serious and constructive first step toward a solution. Congress should carefully consider a number of the elements in Treasury's proposal when it crafts legislation. However, the Treasury proposal as a whole should not be viewed as meeting the requirements of an adequate solution.

Treasury's proposal would provide that cash balance and other hybrid plans do not violate the age discrimination rules if they satisfy the defined contribution standard for avoiding age discrimination (similar to item 1 in the list of 11 basic elements above). The so-called "whipsaw" restrictions would be eliminated, so that cash balance plans would be permitted to distribute a participant's account balance as a lump sum distribution provided that interest was not credited in excess of a market rate of return (similar to item 9 in the list of basic elements above).

The conversion protections – which would apply only to future conversions -- would take two forms. First, wearaway of the normal or early retirement benefit would be prohibited for all participants (see item 2 above). Second, a "hold harmless" period would apply for the first five years after a future conversion: benefits earned by any employee under the cash balance plan would be required to be at least as valuable as the benefits the employee would have earned under the traditional plan absent the conversion (compare to items 3 and 4, above). A plan sponsor would also satisfy that requirement if it grandfathered current participants under the traditional benefit formula or gave them a choice between the traditional formula and the cash balance formula.

The conversion transition protections would not be plan qualification requirements or, apparently, requirements under Title I of ERISA. Instead, a 100 percent excise tax would be imposed on the plan sponsor equal to any shortfall between the benefits actually provided by the cash balance plan and the benefits required. However, to provide relief to companies "experiencing adverse business conditions," the excise tax would be limited to the greater of the surplus assets of the plan upon conversion or the sponsor's taxable income. The proposal would be effective prospectively, with legislative history stating the intent that no inference be drawn as to the status of cash balance plans or conversions under current law.

B. Comments

A number of elements in the Treasury proposal invite particular scrutiny. For example --

- While some would regard any required "hold harmless," grandfathering, or choice as excessive, many would view the five-year limitation on that protection in the Treasury proposal as unduly brief. A long-service participant in his or her fifties or late forties, for example, might well be exposed to a significant reduction for an extended period of employment after the five years have elapsed.

- The conversion protections under the Treasury proposal are not limited to a specified protected class of older and longer-service participants. This gives the proposal the appearance of applying more broadly than many actual or proposed transition provisions that limit the required protection to those participants who have reached a specified age or years of service or both (such as a specified number of age and service "points"). Treasury's decision not to limit the class of participants required to be protected may well reflect a concern about very substantial discrepancies between the treatment of participants who are on different sides of the eligibility line. The benefits realized by a protected participant from a hold harmless transition provision could be quite significant, and would contrast starkly with the lack of any such benefits for a participant with only a few months less service or age. Others would argue, however, that some element of arbitrary line-drawing is inevitable in this type of undertaking, and that the amount of transition benefit for those who barely qualify for the protected class might be sized appropriately without falling into excessive complexity.

- While the duration of the protective provisions is limited under the proposal, it appears that plan sponsors would not have the flexibility to provide less than the full amount of benefits that participants would have earned under the traditional formula. Some would favor this approach, but others might advocate for allowing employers the flexibility to give something less than full protection during any transition period, i.e., partial continuation or preservation – sufficient to meet a specified standard -- of the benefits that would have been earned under the traditional formula. The Treasury approach would not necessarily accommodate techniques such as age- and service-weighted pay credits that might provide substantial transition relief but less than the full benefit participants would have earned under the traditional formula.

- The apparent decision to omit the protections from the plan qualification rules and Title I of ERISA raises questions regarding enforcement and remedies. An indirect Title I right might arise in certain cases, specifically where the plan provisions reflect the transition protection requirements but the employer fails to comply.

- With respect to the exception for employers with no taxable income, there is a threshold question whether a company in financial distress should be allowed to undertake a conversion without protecting older participants. Some would argue that when plan sponsors need to save money as a matter of survival, it is not important or necessarily desirable as a matter of policy to ensure that they have the option of realizing savings through a cash balance conversion that does not adequately protect older employees (as opposed to other means of saving money, perhaps including more direct reductions in benefits). Others would be swayed by the concern that a likely alternative in such circumstances might be an outright plan termination or freeze, but may nonetheless view the scope of the Treasury exception as unduly broad. As currently described in the Treasury documents, the exception to the excise tax appears to allow avoidance of the protective requirements by plan sponsors that are not in extremis but that have arranged their affairs so as to report little or no taxable income in a given year.

- Many would view the purely prospective nature of the Treasury proposal as desirable (e.g., on the basis that plan sponsors should not be required to have predicted the protective requirements before they were enacted). Others would prefer past conversions to be addressed by legislation in some fashion. Some would contend that at least the plan sponsors that converted after the IRS declared its moratorium on conversion-related determination letters (September 15, 1999) -- and after the public notice shortly thereafter stating that the Treasury and IRS were reconsidering the application of the plan qualification rules to conversions – should be deemed to have been on notice and to have assumed the risk. Others would argue more broadly that participants affected by past conversions undertaken with little or not transition protection should be protected now at least to some practicable extent. Still others would have an interest in a provision making clear that many past conversions – those that met a reasonable and flexible standard specified in legislation – were valid and will be protected from challenge. These issues are discussed in the body of the testimony.

Chairman JOHNSON. Thank you. I thought maybe The Brookings Institution taught you how to talk long. The Chair recognizes the Chairman of the Full Committee, Mr. Boehner, for questions.

Chairman BOEHNER. Thank you, Mr. Johnson, and let me thank our panelists for their valuable insight and their testimony as we seek to find a rational answer for how to improve the pension system for American workers.

As I was listening to the opening statement from the Chairman and Mr. Andrews and some of you, I began to remind myself that the pension system in the United States is a voluntary program on behalf—from employers on behalf of their employees. And when we seek to legislate, you know, fix the existing problems, that we just can't lose sight of the fact that this is a voluntary system that we have in America that's worked fairly well. Is it perfect? No. But it is a voluntary system.

Secondly, as I listen to Mr. Kent outline the principles of reform; solvency, predictable, transparent, flexible, and simplicity I began to ask myself if we were talking about Social Security or the pension system. And if you look at the problems that we have in the defined benefit pension system in our country today, it's really not a great deal different than the problems that we have in the Social Security system in America today, especially, in that people are living a great deal longer than when most of these plans were initiated and put together.

And when you begin to look at the mortality tables, you can begin to understand why many of the defined benefit plans that we have are facing the kind of problems that they're facing, especially, in older industries.

And so I also want to take a moment to say thank you to many of you that are in the audience for your input, your help, and your advice as we were finally completing the pension bill that the President signed into law several weeks ago. I don't know why something so simple turned out to be so difficult, but welcome to the U.S. Congress.

There's one other point that I want to make, and I think Mr. Andrews touched on it, and I want to touch on it, as well. What we seek to do here is to find a way to simplify the rules around defined benefit plans in meeting really two goals—two competing goals. One is to simplify the regulatory structure so that plans know what they have to do, when they have to do it, and can contribute when they're most able to contribute.

Now I think the entire DRC section, while it was put in in '87 and updated in '94, was never really tested until we got to 2001, 2002, 2003 and we found out that it was a meat axe that just doesn't work. But we've got to find a way to make these simpler,

including—including the safe harbor of a cash-balance conversion, which once we get all the politics out of the way—which we never quite do around here—truly is a way to strengthen the defined benefit system.

So we've got to do all that on one side while at same time insuring that the commitments that employers are making to their workers are kept. And that gets around to the solvency issue. And the reason I bring this up and make a point of it is that as we go through this process over the next year or so we're going to be working with many people to find the right set of rules for defined benefit plans of all sorts.

But I just want everyone to know on the other side of this equation we expect people to make contributions to their plans, and it's—because I've had people suggest these changes, these changes, and someone suggested something to me this morning about a group of plans trying to find a way to give us good advice and all get on the same page.

But I just want everybody to know that these are—this is the tightrope that we're walking, because when we want people to make contributions and to keep their plans, we don't want to over burden them and push them out of the process. But at the same point if you're going to have this plan, you're going to make commitments to your workers, you've got to be able—you've got to be willing to meet your commitments and to make those payments.

And so, Mr. Kent, I'm very pleased with the points that the actuaries are making. We need your help in this process, and I think that the five or six goals that you outlined are the same types of goals that we have as we do this.

Mr. Iwry, when it comes to cash balance, we've got to keep beating the drum. My colleagues on both sides of the aisle by and large understand that cash balance conversions in 99 percent of the cases were done correctly. There were only several cases where people were rather clumsy about how they pursued it in their conversion, but we have to have real rules that provide clear indications to people as to how they can do it where they don't feel like they're exposing themselves to endless litigation. There's enough litigation out there already.

So that—I've got another meeting to go to, but I just want to say thanks for being here and thank all of you for your help as we've been through this process and we will continue to go through this process.

Chairman JOHNSON. Thank you Mr. Brookings—I mean, Mr. Boehner. You're all right, John. I don't care what they say.

Chairman BOEHNER. As I'm fond of saying—and I have 11 brothers and sisters. My dad owned a bar—I can smell it a mile away.

Chairman JOHNSON. Thank you for being here and thank you for your comments. Mr. Andrews, you're recognized for 5 minutes.

Mr. ANDREWS. I liked what you said, John. I don't care what Sam says. I thought it was pretty good. I'd like to thank the witnesses for their testimony this morning. It was outstanding, and I hope that you will stay engaged with the Committee as we go forward in the process of trying to develop legislation.

I wanted to ask Mr. Heaslip you favor making permanent the 30-year bond rate that was done in the bill the President just signed,

as opposed to the administration's discussions of the yield curve. I'm sympathetic to your point of view. I think the last thing in the world we probably need now is another change to a variable instrument, at least, in this context. I wonder if you could tell us what you think is superior about the 30-year rate when compared to the yield curve.

Mr. HEASLIP. A couple of thoughts on that. While I think there's still a lot of questions about the yield curve, which need to be answered, so we're working on partial information here, there's probably two aspects to the interest-rate question that I think are important to consider.

The first is what is the basis for the interest rate. The use of a long-term corporate bond rate has appealed because it's publicly available, it's very transparent, it's simple to understand—

Mr. ANDREWS. Pretty easy to understand. You look it up on the Internet and you know what it is, right?

Mr. HEASLIP. Exactly. I'm not sure the same is true of a yield curve. It will vary from company to company. It will be difficult to explain to participants, and I don't—it's not something you can just look up on the Internet. So simplicity and transparency is one argument for the corporate bond rate.

I think the second part of your question gets to over what period of time the rate will be based. The proposals that I've seen on the yield curve speak of it as a spot rate or a point-in-time rate, which, I think, by definition is likely to be more volatile than a corporate bond rate, which is averaged over a three to 5-year period. That volatility in the rate leads to volatility in funding requirements, and volatility in funding requirements, frankly, is one of the things we're really struggling with.

Mr. ANDREWS. I agree with you and I think that we don't want to let precision in the rate be the enemy of the greater substantive point. That if one of the reasons why people are walking away from defined benefit plans is the volatility of their funding obligation, we might be very, very precise about very few LANs that are left in the universe. I wouldn't want to see us elevate precision to the level of a religious principle. So I'm interested in hearing more thoughts about that.

Mr. Iwry, I want to ask you about safe harbors for cash balance conversions that have already taken place. The administration has put rules on the table, which you regard as a constructive first step. What do you think we ought to do about an employer who has already done a cash balance conversion that's consistent with those rules? In other words, the rules essentially say let's give employees a choice between the lump-sum-aggregate choice and the continued defined benefit traditional choice.

If a company has already done that, do you think that we should create a safe harbor for them so they can't be sued for doing it?

Mr. IWRY. Mr. Andrews, if the company is already given that kind of choice to participants between continuation of the old plan and the new cash balance format, I certainly think that they ought to be treated as having done a more than adequate transition for their older workers. But that kind of conversion should be protected from challenge.

I think what we have to be sensitive about is how to deal with past cases in a way that's fair to the sponsor, as well as the employees affected, if it doesn't have unintended consequences. There are other conversions. People could pay a little less than that who might feel that they're—might see themselves not needing that safe harbor.

Mr. ANDREWS. I think we have to divide the world into three universes here; plans that have already made a conversion but done so in a way that impairs the fair, legitimate interests of pensioners; plans that have done a conversion already but have not impaired those fair interests, and I believe those plans should see a safe harbor; and then plans which are considering it in the future, so we can influence their behavior in a positive way. And we're interested in your precise thoughts about how to do that.

I did want to close with Mr. Kent. You said a lot of provocative and interesting things. Two of the most interesting things I thought were your views on raising the ceiling on contributions that can be made through pre-funding. How high do you think that ceiling should go?

Mr. KENT. There are clearly within my profession a lot of different levels. We've heard as much as 130 to 165 percent of the current liability. It has to be rationalized to address the solvency issues, and part of it is going to depend on what liability or obligation we define as a bench mark for solvency.

But if it were at 130 percent of the current liability, that's one bench mark that could be justified. But it would not have taken plans through the kind of economic scenario that we just experienced over the past 3 years. There would still be plans that would fall into an insolvent position as a result of that.

Mr. ANDREWS. I'm going to stop, but I would just ask each of three witnesses to consider this question. Should that threshold be set by regarding—well, what set of economic parameters should be used to set that threshold? If you want to take a worse-case-scenario idea for setting the threshold, you would make it very, very high. You assume the worse and let people put away money in good times, or should the scenario be more optimistic?

And the second part of that question is other than revenue implications for the treasury, are there any other policy considerations we should think about in setting that threshold? Obviously, it will cost the treasury some money in the short run the higher you make the threshold. Although, arguably, I think it may avoid Federal outlays and PBGC if you make the threshold higher, so I'm not sure at the end of the day what it costs.

But the question I would ask is supplement the record—because my time is up—is other than revenue implications, what other considerations should we take into account when setting the threshold for pre-funding pension obligations? Thank you, Mr. Chairman.

[The provided material follows:]

Letter from Kenneth A. Kent, Academy Vice President, Pension Issues, American Academy of Actuaries, Washington, DC, Submitted for the Record

AMERICAN ACADEMY *of* ACTUARIES

May 14, 2004

The Honorable Sam Johnson
Chairman, Subcommittee on Employer-Employee Relations
House Committee on Education and the Workforce
U.S. House of Representatives
Washington, DC 20515

The Honorable Robert Andrews
Ranking Member, Subcommittee on Employer-Employee Relations
House Committee on Education and the Workforce
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Johnson and Ranking Member Andrews:

At the April 29, 2004 hearing on "Examining Long-Term Solutions and Strengthening the DB Pension System," you asked what the parameters should be for setting a maximum threshold for deducting contributions to pensions plans (along with other considerations, such as revenue issues). The American Academy of Actuaries[1] appreciates the opportunity to respond to this very important question. In fact, we have completed a paper on this very subject, which we have attached. In this letter we provide a brief response to your specific questions. More details can be found in the attachment.

First, I want to frame the question within the principles I introduced in my oral testimony. We refer to flexibility, which addresses not only funding flexibility, but also management of the funding obligation under an adverse business cycle. These concepts also touch on the principle of predictability and the opportunity for employers to fund their plans so as to mitigate the financial strains that occur during adverse business cycles. Our suggestions should be coupled with the flexibility for employers to have access to super surpluses if the situation arises, as well as to expand deductible contribution limits.

It is important to balance the value of allowing companies to maintain a well-funded plan over strengthening the funding of all plans. Increased deductions for stronger companies do not address the need for better funding of weaker plans sponsors; so minimum-funding issues will also need to be addressed.

At the hearing, I suggested that pension plans could be better funded if laws allowed plan sponsors to deduct more in good years — for example, until plan assets reached 130 percent or 150 percent of current liability (CL). Rep. Andrews asked what parameters Congress should use in setting those limits.

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

Possible Margins: In a world where there is no concern about tax revenues, defined benefit plan sponsors could be allowed to deduct up to the total present value of benefits, including benefits that can be earned through future employment with the company. At this point, the employer would not have to contribute any additional funds (except for amounts that might be needed as experience varies from expected or as new employees are hired). Tax revenues are important, however, so current rules limit deductions to 100 percent of CL for accrued benefits (or the ongoing full-funding limit, if greater). Some have proposed increasing this limit to 130 percent or 150 percent of CL. In order to assess how much margin would be appropriate, we have estimated the margin that would have been needed to avoid underfunding in past economic periods.

One approach would be to determine how much margin would have been needed to avoid underfunding in past economic periods. The Academy has created a program that models this approach back to the 1920s, and we would be glad to make it available to you.

The Senate Finance Committee, in its 2003 markup of HR 3108, would have allowed sponsors to deduct contributions until the plan was funded to 130 percent of CL.[2] While a 30 percent margin would have kept plans from falling below 90 percent funded (using current liability, not termination liability (TL)) in most economic periods, it would not have been adequate for the depression years (dramatic decreases in stock prices) or the years 2000-2003 (dramatic decreases in stock prices and interest rates). If policy-makers want the margin to cover an event like this most recent period, then approximately 150 percent of the CL or more might be needed. For example, if policy-makers wanted enough margin to keep assets above 100 percent of CL during this most recent period, 155 percent would have been needed (or 160 percent for a plan covering younger participants).[3]

Contingent Liabilities: All plans have one significant contingent event, which is an involuntary plan termination. The behaviors of plan participants change dramatically under these scenarios — they might retire earlier and they tend to elect options that maximize the value of their benefits. In addition, there are other contingent events, such as shutdown benefits. Whether the possibility of these contingent events occurring justifies 150 percent of CL threshold or supports the development of additional deductible contributions needs to be considered.

Revenue Concerns: We recognize the need to balance concerns about pension security with tax revenue impact. To address this concern, a percentage lower than 160 percent could be used, or the use of a larger margin could be restricted (to plans covered under Title IV of ERISA, for example). Another way to reduce revenue losses would be to allow deductions up to 130 percent of CL and eliminate the excise tax on contributions up to 160 percent of CL. This approach would allow employers to reduce future contributions and retain an accrued deduction if and when the funded status fell below 130

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[2] For example, see the Senate Finance mark up of IRC §404(a)(1)(D).

[3] What should this margin be? A plan funded to 130 percent of termination liability (TL) on January 1, 2000 with typical assets of 60 percent in equities (50 percent large cap and 10 percent small cap) and 40 percent in bonds similar to the Lehman Aggregate, would be only 83 percent funded on January 1, 2003, assuming the plan's equities fell 30 percent (as they did over the 3-year period from the January 1, 2000 to January 1, 2003, per Ibbotson large and small cap indices) and interest rates fell 150 basis points (as they did during this same period). A plan funded to 155 percent of TL would be 100 percent funded on a TL basis. In addition, larger margins might be needed to handle other situations. For example, the 155 percent margin would need to be higher for plans with higher durations (e.g., 160 percent would have been needed for plans with a duration of 15 reflecting a younger average population). These calculations assume that companies continue to make their annual contributions; the PBGC may be interested in increasing the target percentages to allow for a greater cushion in case weaker companies do not make these contributions. Other factors could increase or decrease the desired margin, including asset allocation and whether smoothing techniques are used. For example, if we kept a plan funded above 100 percent of CL, it still might be funded at 90 percent on a TL basis.

percent. Alternatively, Congress could limit annual contributions (e.g., to 10 percent or 15 percent of CL each year or at least the cost of benefits accruing during the year) when assets exceed 100 percent of CL.

The revenue losses generated by this change may not be as great as expected, because:

(1) Most plan sponsors will not take full advantage of the threshold because they would rather invest the funds in the company and hope for a better return through company growth. Also, if they put excess funds into the pension plan, and the assets have excess returns, the plan could become so overfunded that it would never need all the funds. However, employers are loathe to contribute enough to create an overfunded situation because the excise and income taxes give the federal and state governments 95 percent of the reversion (depending on state tax law), while the plan sponsor only gets 5 percent. Certain techniques can be used to reduce this to 65 percent, but they require employers to provide greater benefits that they may have intended, so the employer never actually gets direct use of the funds.[4]

(2) If a plan sponsor takes advantage of this provision now, smaller contributions would be required in future years. In fact, plans funded to 150 percent of CL could have excess returns in future years that can fully exceed the annual contribution. Any additional deductible contributions may not be allowable in the next few years. Thus, a large revenue loss in one year could be followed by more tax revenue in a later year, which could help smooth out revenue income for the US government.

Further Ideas: We appreciate your request for further ideas on this subject. U.S. pension funding rules create volatile contribution patterns and can discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong, and require substantial contributions when the economy declines and plan sponsors can least afford them. Thus, the funding rules create cyclical economic problems for the country. They exacerbate the economic cycle by helping reduce employer cash flows in the good times and hurting them in the bad times. We have seen a number of companies, in a wide variety of industries, whose survival is threatened by the cash contribution requirements of pension plans that were considered to be reasonably well funded (or even overfunded) just a few years ago.

The following are a number of additional approaches that could accomplish this goal of adequate margins. We are not suggesting that all of these approaches should be adopted; but rather that legislators consider a combination of these approaches that would best balance the need for additional security and stability in pension funding with other legislative objectives.

- **Increase the deduction limit to cover key thresholds:**

  — ***Increase year-end unfunded current liability,*** so the plan sponsor can contribute an amount necessary to fully or partially offset asset losses, reductions in the government-mandated current

[4] Our attached paper suggests remedies to this problem that could satisfy the concerns of employees and the Department of Labor. For example, plan sponsors could be allowed to access plan surpluses (without excise tax) only if the assets exceeded a high threshold, and/or only if they were used to provide other employee benefits, such as active employee health benefits. This ability could be prohibited in union plans (multi- and single-employer) where benefits are bargained, or could be allowed if the union were involved in the decision-making as to where the funds were used. In addition, the prohibitively high 50 percent reversion excise tax used on plan termination could be lowered to something that reflects the tax advantages of the funds in a pension plan in exchange for increasing the income tax rate to the full corporate rate, even where the company tax rate might be lower at the time of the termination or reversion if permitted from a super surplus funded plan.

liability rate, or "significant events" that occur during the plan year. Over the past few years, many companies wanted to contribute large amounts at year-end to avoid adverse accounting impacts caused by an underfunded plan, but they did not do so because they could not deduct the full contribution (and it would have been subject to an excise tax). This change would address that problem.

— ***Increase the amount necessary to avoid the PBGC variable premium.*** If the actuarial accrued liability is greater than the CL, a plan may have to pay PBGC variable premiums even though it cannot deduct any further contributions because of the full funding limit in section 404. If the vested current liability using PBGC's required interest rate is larger, then employers should be able to deduct contributions to fund up to this amount so that they can avoid the PBGC variable premium. We believe the loss in premium income for the PBGC would be far outweighed by the additional security of a better-funded plan, for not only employers and participants, but for the PBGC as well.

— ***Eliminate the 25 percent of covered payroll restriction on combined defined contribution/ defined benefit deductions*** so that appropriate levels of contributions can be made to secure defined benefit promises without discouraging employers from making contributions to employees' defined contribution accounts. Past proposed legislation that would allow deductions up to 6 percent of payroll to a defined contributions plan in addition to the 25 percent of payroll (or UCL if greater) are a good, partial step in this direction. This could be restricted to PBGC-covered plans, if desired.

- **Expand benefit commitments included in current liability for maximum funding purposes to include:**

  — ***Lump sum payments***, which by law reflect a subsidized interest rate. However, under IRS rules, the current liability cannot reflect this subsidized interest rate – so the plan's funding falls further behind with each lump sum payment made.

  — ***Automatic increases in benefit limits.*** Under existing laws and regulations, certain benefits cannot be reflected, which can hurt the funding levels of a plan (particularly plans with many participants that have large benefits). This can hurt all the participants upon plan termination (whether they are highly paid or not) if the plan benefits are cut because there is not enough money to cover benefit liabilities. If plans subject to Title IV could fund these benefits, participants in a recently terminated pilot plan would have received more of their accrued benefit from the PBGC.

- **Allow deduction for a contribution equal to the normal cost each year**, representing the growth in benefits attributed to the current year without regard to full funded status. This allows plans to keep up with the expected growth in liability each year. It also avoids contribution "holidays" that may cause employers to get out of the habit of making contributions to the plan, and which may make it that much more difficult to resume funding when necessary. If needed, a cap could be imposed on funding or the deductible contribution could be phased out gradually based on the level of surplus in the plan.

- **Allow smooth "cliffs" inherent in full-funding limits** to avoid unnecessary volatility. The Canadians have developed an approach in which overfunding of pension plans is phased in over five years; funding isn't restricted until the surplus is at least five times the normal cost of the plan.

- **Loosen restrictions on access to surplus pension funds.** Under current law, severe restrictions prevent employers from recouping any excess pension funding, so many employers are reluctant to build a funding "cushion" in case the additional funding ultimately proves unnecessary and the money is trapped in the pension plan. Of course, any approach should balance the need for flexibility that will encourage employers to increase their pension funding with concerns about the security of benefits for participants. Some alternatives include:

  — ***Allow withdrawals of surplus assets***, but only if the funding level exceeds a relatively high threshold (e.g., 130 percent or 150 percent of current liability or the regular full-funding limit if higher). The ownership of these funds potentially rests with the employees, so if appropriate, Congress could restrict these amounts to be used only for other employee benefit plans. In addition, you could allow the funds to be used for other reasons in bargained plans, if agreed to by a representative employee group.

  — ***Define a super surplus*** benchmarked at (for instance) the lesser of 175 percent of current liability, or the present value of all benefits, where withdrawals would not be subject to excise tax but would be subject to the maximum corporate income tax rate regardless of the employers' tax rate at the time of reversion.

  — ***Reduce the excise tax*** (currently 50 percent, in addition to regular corporate income tax) at least for reversions up to a specified percentage of the benefit liability.

We have offered the above alternatives for relaxing the restrictions on maximum contributions to pension plans so that employers have more opportunity to shore up the financial security of these plans when they have the resources to do so. This should increase benefit security for plan participants, decrease the demands on the PBGC, and stabilize the financial requirements for the companies that sponsor these plans.

Members of the American Academy of Actuaries are very interested in working with you and your staffs to discuss these ideas and the possible effects on pension plan participants, sponsors, the IRS, and the PBGC. Please feel free to contact Heather Jerbi, Pension Policy Analyst, and Ron Gebhardtsbauer, Senior Pension Fellow, at 202-223-8196 with any questions.

Sincerely,

Kenneth A. Kent, FSA, MAAA
Vice President, Pension Practice Council
American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

Averting the Next Pension Crisis

In this paper, the American Academy of Actuaries[1] Pension Committee focuses primarily on the maximum tax-deductible contribution rules for defined benefit plans. We are also studying the minimum funding rules, with the goal of simplifying and fixing them without adversely affecting the objectives behind those rules. We are presenting this draft on the maximum rules before our minimum funding ideas are finalized, in response to requests from policymakers. Ultimately, some of these suggestions may require change to mesh with our recommendations for minimum funding

The current pension funding rules tend to produce volatile contribution patterns and discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong – and require substantial contributions when the economy declines and plan sponsors can least afford them. Thus, the funding rules create cyclical economic problems[2] for the country – they exacerbate the economic cycle by helping in the good times and hurting in the bad times. In addition, we have seen in the news a number of companies in a wide variety of industries whose survival is threatened by the cash contribution requirements of pension plans that were considered to be reasonably well-funded (or even overfunded) just a few years ago.

In the 1990s, a number of companies might have contributed voluntarily to their well-funded pension plans, but were discouraged because a contribution
(1) Would not have been deductible,
(2) Would have caused an excise tax assessment, and
(3) Would not have been returned to the employer even if the plan's eventual surplus made the contributions unnecessary.

Not only were employers discouraged from making contributions in past years, but unfortunately, many became accustomed to the contribution holidays. Anecdotally, the budget line item for pension contributions was eliminated at some companies for so long it was forgotten. The subsequent fall in the stock market and very low interest rates made many plans underfunded and triggered the deficit reduction contribution rule. (A chart at the end of this paper shows this graphically.) Now, employers have to contribute unusually large amounts to their newly underfunded pension plans. Some employers

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[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

[2] Some of our members believe that this is also a function of ERISA's policy of diversification of assets across asset classes. If this ERISA policy were changed to allow the use of bonds only (and if employers could be convinced to make greater use of immunized bond portfolios), then smaller margins might be acceptable, but that would be a major change in thinking for pension plans, and needs much analysis before legislating such a change. However, other members believe that diversification remains a prudent and more cost-effective way to invest pension assets – so much debate is needed before any change in ERISA's diversification rules is implemented.

responded by freezing and/or terminating their defined benefit (DB) plans. Others find themselves in bankruptcy, unable to support their pension plans and turning to the PBGC for benefit guarantees.

In this paper we explore ways of reducing this volatility by raising current contribution limits. Ironically, a number of plan sponsors who would have liked to shore up their pension funding (and eliminate adverse accounting impacts)[3] at the end of 2001 and 2002 were unable to do so in a tax effective manner. Had employers been allowed to make deductible contributions, some would have done so to avoid the difficulties they face today, and pension plans (as well as the PBGC) would be in better shape financially. Going forward, employers are now more keenly aware of the risk of declining funding levels, and many might be interested in taking advantage of any changes in the law that would allow them to build larger funding "cushions" against this risk.

On the other hand, we should not overreact to the "perfect storm" -- the rare convergence of poor asset returns, unusually low discount rates, and other factors that have affected pension funding levels. Therefore, we would like to see the rules changed so that employers that are financially able to better fund may do so. At the same time, the funding rules should not unduly strain the existing pension system by requiring large increases in pension contributions that may or may not be necessary in the future.

Below are a number of approaches that could accomplish this goal of allowing margins. We are not suggesting that all of these approaches be adopted; but rather that legislators consider what combination of these approaches would best balance the need for added security and stability in pension funding with other legislative objectives.

The Problem

Contributions are not deductible (and are subject to a 10 percent excise tax) when plan assets exceed maximum tax-deductible limits. In 1987, Congress addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability ("UCL") in IRC §404(a)(1)(D) – but even that has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When interest rates were higher, the full funding limit provided a more generous margin above current liability, at least for pay-related plans, which have the ability to project future compensation increases when calculating the limit.[4] However, when interest rates are low, the deductible limit provides little or no margin[5] for adverse fluctuations in assets or liabilities – and, in many cases (as discussed later in this paper) does not even permit recognition of liabilities for benefits the plan is committed to provide. The years 2000 through 2002 saw a significant decline in the funded status of most plans – because the market value of plan investments fell dramatically *at the same time that* liabilities increased due to lower interest rates. Although conditions appear to be improving, we believe structural changes are necessary if a recurrence of this problem is to be avoided.

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[3] Under FAS87, employers with plans that have any unfunded ABO frequently must record a reduction in net worth equal to the amount of unfunded and unaccrued liability.

[4] For hourly plans (and plans with a large proportion of retirees), the full funding limit can be less than termination liability (because current funding rules preclude anticipating benefit improvements), so these plans have no margin for adverse fluctuations. These are the plans that are now most likely to be underfunded.

[5] Some actuaries suggest that using interest rates below 6 percent for regular ERISA funding today would be most appropriate. However, at one time, the IRS sued certain plans that used a rate below 8 percent.

Suggested Remedies

In a world where there is no concern about tax revenues, defined benefit plan sponsors could be allowed to deduct up to the total present value of benefits, including benefits that can be earned through future employment with the company). At that point, the employer would not have to contribute any additional funds (except for amounts that might be needed if experience is worse than expected or as new employees are hired). Tax revenues are important, however, so current rules limit deductions to 100 percent of CL for accrued benefits (or the ongoing full-funding limit, if greater). Some groups have proposed increasing this limit to 130 or 150 percent of CL. In order to assess how much margin would be appropriate, we have estimated the margin that would have been needed to avoid underfunding in past economic periods.

The Senate Finance Committee, in its 2003 markup of HR 3108, would have allowed sponsors to deduct contributions until the plan is funded to 130 percent of current liability (CL).[6] While a 30 percent margin would have kept plans from falling below 90 percent funded (using CL, not termination liability (TL)) in most economic periods, it would not have been adequate for the depression years (dramatic decreases in stock prices) or the years 2000-2002 (dramatic decreases in stock prices and interest rates). If policymakers want the margin to cover an event like this recent period, then 150 percent of the CL or more might be needed. For example, if policymakers wanted enough margin to keep assets above 100 percent of CL during this most recent period, funding levels of 155 percent would have been needed (or 160 percent for a plan covering younger participants).[7] Similarly, we believe that plans with shutdown benefits should be allowed to accumulate additional margin equal to the present value of the additional benefits as if shutdown benefits were triggered on the valuation date.

Revenue concerns: We recognize the need to balance concerns about pension security with concerns about revenue impact. To address this concern, a percentage lower than 160 percent could be used, or the use of a larger margin could be restricted (for example, to plans covered under Title IV of ERISA). Another way to reduce revenue losses would be to allow deductions only up to 130 percent of CL and eliminate the excise tax on contributions up to 160 percent of CL. Alternatively, Congress could limit annual contributions (e.g., to 10 or 15 percent of CL each year or at least the cost of benefits accruing during the year) when assets exceed 100 percent of CL.

In addition, we note that revenue losses may not be as great as expected, because:

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[6] For example, see the Senate Finance mark up of IRC §404(a)(1)(D). If the change is made to the last sentence of §404(a)(1)(A), it would only allow deductions of the normal cost (up to the full funding limit or 130 percent of CL if greater), so it would take a long time for a plan with a large retiree liability (and relatively small active normal cost) to build up a margin. In addition, it should not be in §412(c)(7), because that would require the margin for plans that were immunized with bonds or plans that were planning on terminating. Requiring a large margin for these plans makes no sense, because they would never need it and would be subject to a large excise tax on any future reversion of excess assets.

[7] What should this margin be? A plan funded to 130 percent of termination liability (TL) on January 1, 2000 with typical assets of 60 percent in equities (50 percent large cap and 10 percent small cap) and 40 percent in bonds similar to the Lehman Aggregate, would be only 83 percent funded on January 1, 2003, assuming the plan's equities fell 30 percent (as they did over the 3-year period from the January 1, 2000 to January 1, 2003, per Ibbotson large and small cap indices) and interest rates fell 150 basis points (as they did during this same period). A plan funded to 155 percent of TL in 2000 would be 100 percent funded in 2003. In addition, larger margins might be needed to handle other situations. For example, the 155 percent margin would need to be higher for plans with higher durations (e.g., 160 percent would have been needed for plans with a duration of 15). These calculations assume that companies continue to make their annual contributions; the PBGC may be interested in increasing the target percentages to allow for a greater cushion in case weaker companies do not make these contributions. Other factors could increase or decrease the desired margin, including asset allocation and whether smoothing techniques are used. For example, if we kept a plan funded above 100 percent of CL, it might be funded at only 90 percent on a TL basis.

(1) Most plan sponsors will not take full advantage of the threshold because they would rather invest the funds in the company and hope for a better return through growth in the company. Also, if they put excess funds into the pension plan, and the assets have excess returns, the plan could become so overfunded that it would never need all the funds. However, employers are loathe to contribute enough to create an overfunded situation because the excise and income taxes give the federal and state governments 5 percent of the reversion (depending on state tax law), while the plan sponsor only gets 5 percent. Certain techniques can be used to reduce this to 65 percent, but they require employers to provide greater benefits that they may have intended, so the employer never actually gets direct use of the funds.[8]

(2) If a plan sponsor takes advantage of this provision now, smaller contributions would be required in future years. In fact, since investment returns can exceed bond rates, plans funded to 150 percent of CL could have excess returns that fully exceed the annual contribution. Any additional deductible contributions may not be allowable in the next few years. Thus, a large revenue loss in one year could be followed by more tax revenue in a later year, which could help smooth out revenue income for the US government.

Allow deduction to reflect increases in unfunded liability at year-end

Many companies would have liked to contribute an amount to fully fund their liabilities at year-end so as to improve the plan's funded position and avoid adverse accounting impacts. Such contributions would help participants and the PBGC, and we believe they should be encouraged. However, such contributions may not be deductible under current law. There are several situations in which the plan's unfunded liability at year-end can exceed the unfunded CL used to determine maximum tax-deductible contributions, because the latter does not reflect several items that may increase a plan's unfunded liability during the year, including:

(1) Asset losses that occur during the year, or reductions in the interest rates, (which increase liabilities).
(2) Benefit improvements that are not included in the current valuation because they are adopted or effective after the valuation date.
(3) Increases in liability due to the payment of lump sums with the government-required subsidy. These subsidies cannot be prefunded under IRS rules.

We suggest that employers should be permitted (but not required) to determine the maximum tax-deductible contributions for a year based on estimated year-end unfunded current liability. This could be done using actual year-end market values and current liability adjusted to reflect the approximate effects of changes in the current liability interest rate and other changes -- perhaps using the same principles as currently applied to adjust liabilities for PBGC variable rate premiums to reflect "significant events."

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[8] This paper suggests remedies to this problem that could satisfy the concerns of employees and Labor. For example, plan sponsors could be allowed to access plan surpluses (without excise tax) only if the assets exceeded a high threshold, and/or only if they were used to provide other employee benefits such as active employee health benefits. This ability could be prohibited in union plans (multi and single employer) where benefits are bargained, or could be allowed if the union was involved in the decision-making on where the funds were used. In addition, the prohibitively high 50 percent reversion excise tax used on plan termination could be lowered to something that reflects the tax advantages of the funds in a pension plan in exchange for increasing the income tax rate to the full corporate income tax rate, even where the company's tax rate might be lower at the time of the termination.

Allow deduction up to the amount that will eliminate the PBGC variable rate premium

Similarly, employers may wish to fund the amount necessary to eliminate the PBGC variable rate premium for the following year.

One way an employer can do so under current rules is by contributing an amount up to the full-funding limit for the prior year. However, under certain circumstances (i.e., if the actuarial accrued liability under the plan's funding method determines the plan's full-funding limit), current rules may not permit the deduction of the amount necessary to eliminate the variable rate premium. We believe it would be helpful if plan sponsors were allowed to deduct any contributions made up to the amount on which PBGC premiums are based (i.e., the plan's liability for vested benefits using the required interest rate specified in ERISA §4006).

Although implementing this proposal would decrease premium income to the PBGC for plans that receive this additional funding, we believe that the additional security created by making these plans better funded is more valuable to the PBGC – and to plan participants – than the premium income.

Contribute up to the present value of benefits

Another suggestion is to allow employers to contribute additional amounts up to the total present value of benefits on a non-deductible basis but with no excise tax, with the ability to carry their deduction forward to a year in which their contribution is less than the maximum deductible amount permitted by law.

Eliminate 25 percent of covered payroll restriction on combined defined contribution/defined benefit deductions

Current law restricts the deductible contribution to defined contribution plans if the combined contribution for defined benefit and defined contribution plans covering the same individuals exceeds 25 percent of covered payroll. This is yet another impediment for employers who would like to strengthen the funding of their defined benefit plans, although Congress has partially addressed this by limiting the situations in which the 10 percent excise tax applies. If the 25 percent restriction were eliminated for Title IV plans with respect to tax deductions or at least with respect to the 10 percent excise tax, employers could contribute additional amounts to the defined benefit plan without jeopardizing contributions for defined contributions plans. Past legislative proposals that allow deductions up to 6 percent of payroll to a defined contribution plan in addition to the 25 percent of payroll (or UCL if greater) are a good, partial step in this direction.

Allow funding for future benefit increases in hourly plans

Hourly plans are typically not as well funded as salary-related plans because contributions for future benefit increases may not be deducted under current IRS regulations. Predicting these benefit increases is impossible, but projections of future benefit levels, using an objective rate, specified by law, such as the CPI should be permitted for purposes of determining deductible contribution limits. It would not

make sense to require these projections for minimum contributions, since the plans may or may not ever have any more benefit increases. Requiring these projections could also complicate the bargaining process, so it is important that these projections be allowed, but not required. Note that under current law even those benefit increases already negotiated but with effective dates in future years, are not included in CL so are not reflected in maximum contribution limits that reflect CL.

Multiemployer plans

Proposals to allow deductions up to 130 percent of accrued liabilities are also important for multiemployer plans because their contributions are generally fixed for the length of the bargaining period. If investment returns are unusually good (as in the 1990s), plan assets could easily exceed the plan's full funding limit, which as discussed earlier, may not include future amendments increasing benefits). This will cause the fixed contributions to be non-deductible (and subject them to an excise tax). To alleviate this problem, multiemployer plans increased benefits (sometimes to surprisingly high amounts) in order to make the contributions deductible. With the recent fall in asset values, they now are faced with the opposite problem. The fixed contribution is now less than the minimum required contribution, which will subject these plans to a 5 percent excise tax, and eventually a 100 percent excise tax. However, since accrued benefits generally cannot be cut, it can be difficult – if not impossible - to fix this problem. The best solution is to not force unneeded benefit increases when assets do well. The best way to do this would be to exempt multiemployer plans from the 404 maximum deductible limits, as suggested at the April 29, 2004 House hearing on pension funding. Experts on the panel noted that plan sponsors would not take undue advantage of this exemption because contributions made to multiemployer plans can never be used for other purposes. If Congress is unable to exempt these plans, then other ideas in this paper, such as allowing deductions up to 150 percent of CL for multiemployer plans could help to resolve this concern.

Anticipate automatic increases in maximum benefit limits

IRC §404(j) and §415(b)(2)(E)(iv) provide maximum compensation and benefit limits for qualified pension plans, which are subject to annual inflation adjustments. These limits were established to curb excessive benefit levels. (For example, the current maximum pension benefit at age 65 is $165,000 per year, and the compensation on which benefits are based on today is $205,000). IRS funding rules, however, do not allow employers to anticipate future increases in these limits when determining minimum or maximum funding requirements for defined benefit pension plans. This clearly works at cross-purposes with the concept of advance funding for pension obligations.

This is particularly true for defined benefit plans with large benefits for everyone (e.g., plans covering airline pilots and in inflationary periods (during which particularly rapid increases in the benefit limits will occur). We believe it would be desirable to permit (if not require) pension funding rules to make reasonable provision for future increases in benefit limits.

Many large plans automatically incorporate the increase in these limits for future retirees each year – but since they cannot anticipate them when calculating funding obligations, the funding for these increases is delayed even though the employer is committed to provide them. We recommend inclusion of these automatic benefit increases for defined benefit plans, at the very least for maximum deductible purposes, and preferably for minimum funding purposes as wel. This also would help participants' benefit security. For example, workers and retirees would have received more of their accrued benefits from PBGC in a recently terminated pilot plan had funding of these benefits been mandated.

Reflect lump sum payments in current liability

Plans that offer voluntary lump sum payments must provide them using the subsidized interest rates required under IRC Section 417(e). These low interest rates can dramatically increase the liability associated with these pension benefits (over the cost of the pension required by the DRC rules in section 412(l)), and employers cannot avoid this liability (at least for already-accrued benefits) by amending lump sum benefits out of the plan without violating anti-cutback rules.

However, even though plan sponsors are committed to providing these benefits once they are in the plan, IRS guidance in Notice 90-11 does not permit them to reflect the additional cost in current liability.[9] This restricts their ability to contribute amounts needed to support the plan. We recommend inclusion of the full lump sum amount in current liability, at the very least for maximum deductible purposes, and preferably for all purposes.

Allow deduction for normal cost in all years

One useful approach is to allow employers to make a deductible contribution to the pension plan every year while a plan continues to provide additional benefit accruals even if the plan is currently fully funded. That would avoid the recent problem of employers not budgeting for contributions to their pension plan (because they hadn't been deductible). What should this contribution be? Some actuaries have suggested the normal cost under the plan's funding method (or if not applicable, the entry age normal cost or projected unit credit normal cost) or the present value of current accruals (in the DRC calculation). Others have suggested the aggregate method normal cost (or open group normal cost) [10] be deductible in all years. We note that one reason assets exceed actuarial liabilities at certain points in time is because asset returns have been better than expected. If assumptions are correct on average, then asset returns could be worse than expected at some point in the future. Given this dispersion of asset returns, the normal cost using an average interest rate may be appropriate every year. If necessary, a cap could be imposed on funding – e.g., the rules could specify that no contribution is deductible to the extent it results in assets greater than the total present value of accrued and projected benefits for all current plan participants.

Normal cost phase-out

A more modest alternative to the above suggestion would be to phase out the deductible contribution gradually based on the level of surplus in the plan, instead of it being a cliff as under current funding rules. For example, a plan sponsor could deduct normal cost minus the surplus divided by 5. Thus, when the surplus is zero, normal cost is deductible. When the surplus is five times the normal cost, it would be zero. The deduction rule would phase out between those two surplus amounts.

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[9] This is particularly true when the lump sum rate is below the range for the current liability rate – and that has happened many times over the past 10 years.

[10] The IRS could be instructed to grant automatic approval for plan sponsors to use the aggregate or open group method for their maximum contribution in any year.

If this general approach is acceptable, policymakers in the U.S. could adjust the actual mechanics, if desired. For example, the threshold for determining surplus could be 130 percent of current liability (or the FFL if greater) and/or the phase-out period could be extended to 10 years or some other period.

Allow, incent, or mandate?

To minimize controversy regarding these ideas, we suggest that the rules *allow* the normal cost contribution, not *require* it. On the other hand, some policymakers may suggest that underfunded plans (or even plans funded below 120 percent of CL) should be required to contribute more. Because of the importance of this issue, we suggest that changes in both the minimum and maximum funding rules be considered carefully to make sure that we have a logical and cohesive structure for addressing the funding of DB plans.

We also note that strong incentives exist for companies to contribute more. For example, if assets fall below the accumulated benefit obligation, there can be adverse implications for the employer's corporate balance sheet. If assets fall below the liability for vested benefits, companies must pay an additional premium to the Pension Benefit Guaranty Corporation (PBGC). If assets fall below 90 percent of current liability, contributions can increase dramatically due to the DRC. Recent drops in the market have provided a good reason for employers to increase their funding margins and build a "cushion" to protect against adverse experience.

A list of the penalties and restrictions follows. If policymakers want to increase the incentives for funding, then a threshold for one or more of the penalties could be increased (e.g., the threshold for security) or restrictions on lump sums and benefit accruals could be added.

If the funding ratio falls below*	Then
125%	No §420 transfer to the company post-retirement health plan Company can not use the prior year valuation
110%	Restrictions on the size of lump sums to the top 25 & possibly other HCEs
100%	Accounting rules may force a hit to net worth (uses 100 percent of ABO) PBGC variable premiums are payable (lower interest rate on vested CL) Companies must pay quarterly contributions PBGC files lien on company if missed contributions > $1 M PBGC financial filings required if underfunded over $ 50 M Certain corporate transactions must be reported to the PBGC if the plan is underfunded Bankrupt firms may not increase benefits
80%/90%	Additional deficit reduction contributions required Notice to employees with funding ratio & PBGC guarantees required
60%	Security required for plan amendments

*Note that the above ratios are based on varying measures of liability

Withdrawals and transfers

Incentives for employers to increase their funding margins may not work unless we also address the one-sided nature of the funding equation – employers who try to protect the plan by making additional

contributions have very little opportunity to use those contributions if it later turns out that they weren't needed. For example, if an employer contributes enough to increase a plan's funding ratio to 150 percent, and then the investments do very well, the plan may become extremely overfunded.

If the employer needs some of the surplus pension money, its only viable option may be to terminate the pension plan. Not only is this a difficult, complex process that hurts employees by freezing their accruals, but also 85 percent of the margin would have to go to the federal government and even more would be paid in the form of state and local taxes, leaving very little for the plan sponsor who funded the contributions.

One approach would be to allow a withdrawal only if:

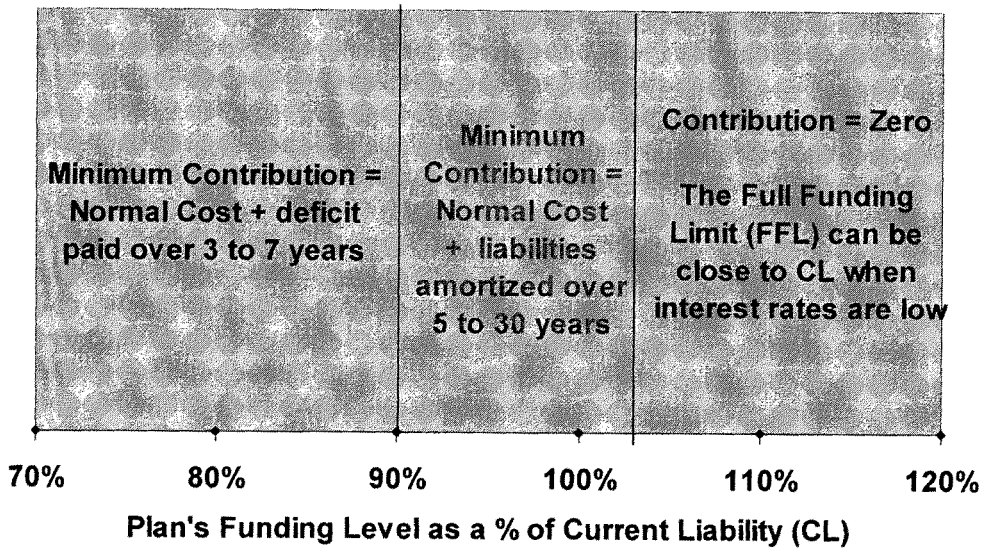
- Assets exceed some high threshold (e.g., 130 percent or 150 percent of current liability, present value of all benefits on a termination liability basis or the ongoing actuarial accrued liability if greater), and
- The uses of the withdrawal could be restricted to employee benefit plans.
- If the plan is subject to bargaining, then the union could be involved in determining where the super surplus is transferred, and how much surplus is transferred.

If the above requirements are met, the excise tax could be waived just as in Section 420 transfers to retiree health plans. In addition, the excise tax for reversions (and other withdrawals when assets exceed the above threshold) could be defined as that amount that eliminates the tax shelter on the withdrawal (based on some assumption as to how long the surplus was in the plan). This percentage could be lower than the current 20 percent and clearly lower than the 50 percent excise tax rate.

Summary

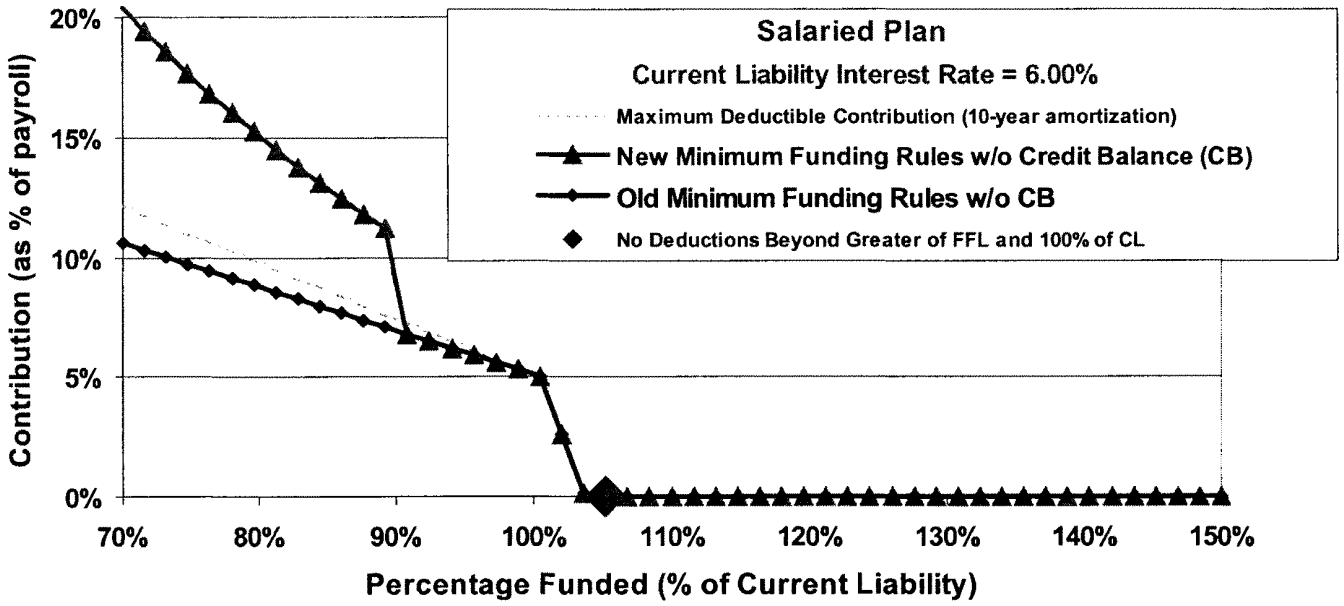
Pension plan funding levels dropped dramatically over the past few years causing financial distress to plan sponsors and concerns to plan participants and the PBGC. In light of this experience, plan sponsors may be more willing in the future to make contributions in all years, even if plans are modestly overfunded under current measures. That, in turn, would positively impact funding levels and thereby reduce the chance of a future pension funding crisis. To further this policy goal, Congress could make the contributions deductible (or at least not subject to the § 4972 excise tax), expand IRC §420 provisions for transfers to other benefit plans, and reduce the prohibitive 50 percent excise tax in §4980(d) on reversions. Various proposals have been provided in this paper. We at the American Academy of Actuaries are very interested in working with policymakers to discuss such rules. Please feel free to contact Heather Jerbi, Pension Policy Analyst, and Ron Gebhardtsbauer, Senior Pension Fellow, at 202-223-8196 if you would like to discuss these issues further.

Current Contribution Rules



For many plans, the original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels around 90% to 100%). The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

Funding Rules



When pension contributions are not deductible, they are also subject to excise tax. When interest rates are low, extra deductible contributions can not be made to build up a margin.

Chairman JOHNSON. Thank you. If you could respond in writing, we'd appreciate it, all three of you. Thank you very much. The Chair recognizes the gentleman from Minnesota, Mr. Kline, for questions.

Mr. KLINE. Thank you, Mr. Chairman. Thank you gentlemen for being here with us today. I want to identify myself, of course, with the brilliant remarks of our Chairman of the Full Committee. Welcome to Congress.

Mr. ANDREWS. You can tell who the freshmen are around here, can't you?

Mr. KLINE. We want to be sophomores, Mr. Andrews. That's how that works. I've just got a couple of, I think, fairly straightforward questions. There's been quite a bit of discussion today about hybrid plans, and, Mr. Kent, you were the first one to bring that up. Would you take just a minute and lay out for all of us here exactly what that is and what the difficulties might be associated with that.

Mr. KENT. OK, sure. A hybrid plan—and I'll use cash balance as an example—is one which provides a notional amount of defined funds that go into a person's account, and that account is ultimately redefined as a benefit when they reach retirement. So that it still falls under the definition of a defined benefit, because within the plan structure you can determine what type of lifetime income the plan will provide an individual, based on that individual's facts and circumstances; pay and service.

The reason it's called the hybrid is because through that person's working lifetime they're looking at an accumulation of an account balance, which will ultimately be converted. Typically, hybrid plans because they report an accumulation of account balance also offer those account balances to be paid out as lump sums when they reach retirement, which takes—which negates some of the impact of value that traditional defined benefit plans and life annuities offer.

So that's one form of a hybrid plan; something that looks like a defined contribution plan that is structured to deliver a lifetime income at a specific retirement age. Does that address your—

Mr. KLINE. Thank you for the definition. And difficulties with companies and plans moving to that?

Mr. KENT. Well, the difficulties stem from the way in which some companies have transitioned from a traditional defined benefit plan to a hybrid plan and the way in which they have structured those conversions. There is a concept called wear away where some people did not accrue benefits until the accumulation of their account plus the benefits they earned up to that point in time were more valuable than the benefits that they had prior to the conversion. And those are some of the provisions that are in contention in terms of the way in which plans have been converted and how they're being communicated to participants.

Mr. KLINE. OK, thank you very much. Earlier in the hearing today there was a fair amount of levity and conversation about people living to 104 and 94 and all those sorts of things, and it's a very—of course, very real concern that we are living longer and, therefore, having to pay out benefits for a longer period of time.

And, Mr. Kent, I was fascinated to hear you say that you're working on a white paper or something that I was hoping you'd be willing to give us a little preview into. What are you thinking about raising the retirement age and how would you do that? How would you make that transition?

Mr. KENT. And that's not an easy transition to entertain, but what we're doing is we're asking actuaries and the academics to come up with some fundamental theories or concepts that we can apply that say how do you balance the number of years you would expect to be able to retire over the number of years you're expected to work. Because, clearly, that ratio has gotten out of balance as people have been able to retire and have extended years—far more than the seven, if you will, back in 1930 that were expected.

So there should be some ratio. This should also be done in coordination with a phased retirement, because you have two issues. You have people who are clearly at age 65 who are at the top of their game and capable of continuing to work, and you also have some people, particularly in labor industries, where age 65 is as far as they can go or even age 62, and they need some way to phase down from work.

So coupling the concept of changing the benchmark of 65 with a phased—with the ability to phase into retirement would help our workforce move from what has been the historic bench mark for many years to something that would say people should expect to be able to work longer and balance the number of years in which they're in retirement income versus active income.

Mr. KLINE. It just seems like that would be extremely difficult to make that change. You've got expectations of employers and employees and families. Pretty tough load that you're lifting there. Thank you very much, Mr. Chairman. I yield back.

Chairman JOHNSON. Thank you, sir. The Chair recognizes the gentleman from Texas, Mr. Carter.

Mr. CARTER. Mr. Kent—

Chairman JOHNSON. Would you repeat that.

Mr. CARTER. Thank you, Mr. Chairman. I don't think I'll ever live to be 104. Mr. Kent, you talked about the need for contribution predictability. Do you have any thoughts on how to decrease the volatility of these contributions, particularly, deficit reduction contributions?

Mr. KENT. Well, you took a big step by bench marking the interest rates to be used, so that employers had an idea how to move forward and permanently securing a bench mark would help do that.

The deficit reduction issues that employers are dealing with, one, it represents a significant exception, if you will, and the economic conditions that brought them on to the backs of employers in such a quick and severe way. There has to be a way to spread that, whether you put kind of a Governor on there that says the deficit reduction contributions kick in but it should be no more than "X" percent of what they would otherwise have to contribute in order to modify those results or rewrite that entire structure is one component.

Another component may be to require that employers have a continuing obligation to contribute, even beyond what are currently

considered full-funding limits. So that we raise the bar, and employers are in a position to say we still have a long-term obligation, and we're not moving from a year when we have to contribute nothing to a year which we have to contribute 25 percent of payroll.

So there are a number of ideas that we have that we'll be coming out with in a paper that identify how to smooth that process out and make it more predictable for companies to budget for.

Mr. IWRY. Mr. Carter, may I add something?

Mr. CARTER. Yes, please.

Mr. IWRY. I'd like to register one point of disagreement with my colleagues. I think that the short-term interest rate fix that's just been enacted is desirable and necessary. I think that the long-term interest rate for purposes of pension funding should not be considered an issue that has now been presumptively closed and resolved.

I do not think that Congress has given sufficient attention to the level of the interest rate. The argument has been made persuasively and I've joined in that that the 30-year treasury interest rate is obsolete and not workable. The argument has also been made—and I've joined in that—that a rate based on something different like the corporate bond indices makes sense is ascertainable. Apart from the debate over yield curve conversions of that versus spot rates, but the level of the rate that's based on corporate bonds, for example, has not been focused on adequately by Congress.

Should it be corporate bonds minus a certain number of basis points? Should it be "X" percent of corporate bonds? Should it be 100 percent of corporate bonds? That is an open question, and I think that it's in part an empirical matter that Congress should address by using and sharing some of the modeling and data that the PBGC is doing.

Chairman JOHNSON. Have you modeled that?

Mr. IWRY. The PBGC, I think, has modeled that kind of analysis. Personally, I have not but I was part of that exercise, Mr. Chairman, 10 years ago when we tried to reform the funding rules. And it turned out that to make a really rational decision and know the impact on adequate funding for workers, as well as the impact on the plan sponsor, you had to run numbers. And I suggest that Congress could use some more wherewithals from the PBGC or elsewhere to share in the modeling and the number crunching that they do.

Chairman JOHNSON. Thank you. Sorry to interrupt you, Mr. Carter.

Mr. CARTER. I yield back my time, Mr. Chairman.

Chairman JOHNSON. Thank you. The Chair recognizes the gentleman from South Carolina, Mr. Wilson.

Mr. WILSON. Thank you, Mr. Chairman, and thank you all for being here this morning. And, Mr. Kent, you've stated that 401K plans currently have more tax advantages than the defined benefit plans. Would allowing pre-tax employee contributions assist plans with their current funding issues?

Mr. KENT. We introduce it not to assist plans in their current funding issues, because we're not suggesting that employees now be held to help employers fund what they have already held as an obligation based on their program.

What we do suggest is that employers be allowed to design defined benefit plans that you would permit or require employees to contribute a portion of their own income to provide for long-term income net retirement. Very similar to the structure that you have in many public plans in this country where employees contribute to their plans, it enhances the level of benefit that they can retire on, and those contribution are before taxes.

Mr. WILSON. And, additionally, you've been—and there's been discussion about updating the standard retirement age. And so I'm going to give all three of you an opportunity to offend people like we do, and so—and that is to be specific as to how you suggest that the—what target retirement age do you see, and I'd like all three of you to share the blame or credit. And I can't wait for you to enlighten us as to what the retirement age should be.

Mr. KENT. The answer from my part for the Academy is that that's a work in progress, and we hope to answer that question. We do think that you have to couple it with phased retirement, so that what you're really doing is giving the individuals more flexibility but respecting their capability of retiring beyond some fixed age that currently is defined in the code.

Mr. HEASLIP. We tend to look at this, not only on the basis of age, but years of service, and in many of the jobs at our company, people perform very physical work that's difficult to do after say 25 years of service. So one of our goals is to enable people who want to to retire after 25 or 30 years of service almost regardless of their age, because they simply can't keep working. And so that's sort of our soft spot or our sweet spot.

Mr. IWRY. I share that concern that Mr. Heaslip has just articulated. I think the answer to the question what's the ideal retirement age is none. That there need not be a legally mandated retirement age for most purposes. We're really talking about a dozen different purposes here when we ask what should the retirement age be. But for the purpose of determining when people can leave and take their pension, I think that there's a real interest in flexibility.

If I may add regarding your earlier question, pre-tax contributions to defined benefit plans I would suggest that the Committee take into consideration as a caution here that companies may well be invited to frame that issue precisely the way you have, sir. That is to regard it as a way to shift the funding from the company to the employee. That's not necessarily a reprehensible thing to do, but if Congress makes that easier for the company to do and a company is in a position where it would be convenient to do that in a particular year, you can very much start an erosion of defined benefit—of what we really care about in defined benefit plans by turning them into 401Ks.

Mr. WILSON. And I appreciate that very much, and I represent—back on the retirement age I appreciate the concept of flexibility. I represent Hilton Head Island in South Carolina. We have a lot of retirees, and I never cease to be amazed at how so many of them retired and then they go back into consulting and, truly, it should be based on flexibility. So I appreciate that very much.

Mr. Heaslip, currently, there are restrictions on the amount of contributions that employers can deduct. Should Congress consider raising the level of tax-deductible contributions?

Mr. HEASLIP. I do think that would be helpful. We've been fortunate in that our business is strong and we've been able to make voluntary contributions over the past several years. And I think the more you can do to encourage employers to make contributions when business and economic conditions are good the better off you'll be when there's the inevitable downturn.

Mr. WILSON. And at what level would you suggest?

Mr. HEASLIP. I don't really know. I don't have a specific suggestion in terms of the level. Higher than it is today.

Mr. WILSON. Thank you very much, and I yield the balance of my time.

Chairman JOHNSON. Mr. Wilson, I appreciate your remarks. Can I just ask Mr. Heaslip do you think restrictions ought to be placed on lump-sum distributions in a plan if it's under funded?

Mr. HEASLIP. I think that question goes to whom you're trying to protect. Restrictions on lump-sum distributions would penalize plan participants or workers who have probably expected them, but they might benefit the PBGC. And so I tend to come down on the side of participants. And so I would say, no, you shouldn't restrict lump-sum—

Chairman JOHNSON. Yeah. But if a plan is under funded, they're not going to pay the same lump sum probably.

Mr. HEASLIP. I just feel that if companies have made a commitment to provide a lump-sum payment option they ought to follow through on that commitment.

Chairman JOHNSON. Whatever it happens to be?

Mr. HEASLIP. That's right.

Chairman JOHNSON. OK. And that's their choice? The employee's choice?

Mr. HEASLIP. That's right.

Chairman JOHNSON. Mr. Kent, in your written testimony you state that many employers want to switch to cash balance plans to provide employees with a guaranteed portable defined benefit plan, and they don't do it because of the current legal uncertainty. Would the administration's current proposal guaranteeing a minimum benefit level by providing benefits that have not yet been earned encourage more employers to leave the system?

Mr. KENT. It might. The challenge here is, as you heard in the other testimony, is the level of complexity that is added to the process of converting a plan and whether employers will go down that road of complexity and guarantees or identify that there may be a better way to do -- to approach their needs and structures in terms of terminating the plan and looking for the opportunity to afford a cash balance plan in the future.

That I think has detrimental impact to employees, so that if any structure for conversion adds a fair amount of regulatory complexity that's going to be balanced against the fact that—it will be balanced against whether to convert to a cash balance plan or just freeze the current plan and go to some other system that has less complexity.

Chairman JOHNSON. Thank you so much for your testimony today. You guys have been an excellent panel. We appreciate your advice, and, hopefully, we can start the process. So if you would consider yourselves excused, would the next panel please take their seats. Thank you for being with us today.

I will introduce the second panel as they are seated. Before the witnesses begin their testimony, I'd like to remind members that, again, we will be asking questions after the entire panel has testified. And we'll impose a 5-minute limit on all questions.

Our first witness is Timothy Lynch, president and CEO of the Motor Freight Carriers Association. The second witness is John "Rocky" Miller, a partner with Cox, Castle & Nicholson. And the third Teresa Ghilarducci—there you go—associate professor of economics, University of Notre Dame. Thank you all for being with us, and I'd like to remind you that you've seen the lights work, so you understand the 5-minute limit, and I'd appreciate you all adhering to it, if you could. You may begin, Mr. Lynch.

STATEMENT OF TIMOTHY LYNCH, PRESIDENT AND CEO, MOTOR FREIGHT CARRIERS ASSOCIATION, WASHINGTON, DC

Mr. LYNCH. Is it on now? Thank you, Mr. Chairman. Good morning. My name is Tim Lynch, and I am the president and CEO of the Motor Freight Carriers Association, and I too want to add my comments to some of the earlier panelists about thanking both the Chairman, as well as the Committee members, for holding this hearing, as well as the work on the earlier legislation this year.

I am here today as a representative of an association of trucking industry employers, who by virtue of their collective bargaining agreements, are major participants in a number of multi-employer plans. These employers are concerned about the current framework for multi-employer plans and strongly believe that if not properly addressed the problems will only get worse, thus jeopardizing the ability of contributing employers to finance the pension plans and ultimately putting at risk the pension benefits of their employees and retirees.

Mr. Chairman, I have what I consider to be a fascinating statement on the history of trucking deregulation and MEPPA, but inasmuch as I may be the only one in the room who thinks it's fascinating, I'll ask that I'd be able to submit that for the record and we can move to page seven.

Chairman JOHNSON. That's fine. You may all submit your comments to the record. We'll put them in. Without objection, so ordered.

Mr. LYNCH. Thank you. In doing that, though, I would like to draw attention to the attachment to my statement, which shows a list of the top 50 LTL general freight truck companies that were in existence in 1979, and the bold-faced names are the ones who are still in existence. That is a very, very important key element of where we are in terms of our views about how to move forward.

The single most significant problem confronting multi-employer plans in the trucking industry is the declining number of new participants. The multi-employer concept is a workable model if there are sufficient contributions being made today to sustain payment of current benefits, and as we have seen with recent history, heavy

reliance on investment income can leave plans vulnerable to the vagaries of the market.

However, the fact that there is a shrinking number of unionized trucking companies or that people are living longer are beyond the scope of what we are here to discuss today. There are simply some things we cannot change. But as indicated at the beginning of my statement, we believe there are changes that can be made and that reform of the MEPPA statute is both necessary and timely.

We have three areas that we'd suggest reform. Withdrawal liability. It is no secret that the current framework for collecting withdrawal liability is broken. It doesn't collect the unfunded liabilities it was designed to collect, leaving most multi-employer plans and ultimately all other contributing employers in the plan responsible for benefits of withdrawn employers. Withdrawal liability makes multi-employer plans very unattractive to new employers.

The number of unfunded participants, those whose employer has withdrawn from the fund and is no longer making contributions has created such a significant burden at some plans that drastic action may be required. We are aware of one very large trucking industry plan in which half of the contributions—or half of the benefit payments that are made annually are made to beneficiaries who no longer have a contributing employer on their behalf.

We would recommend that Congress direct the PBGC to undertake a comprehensive study of the unfunded participant issue and the financial burden it poses on multi-employer plans. Obviously, plans and the contributing employers cannot survive long term if only a handful of viable companies are responsible for the last 50 years' of trucking industry retirees.

There also needs to be some exploration of alternatives to withdrawal liability that maintain the integrity of the plans but remove the disincentive for potential new contributing employers. Among other things, serious consideration should be given to developing a withdraw formula that will align benefits of employees of withdrawing employers to the amounts that are actually recovered.

Greater multi-employer plans control and oversight. The basic structure of multi-employer plans makes plan design and certainly plan reduction decisions very difficult. Notwithstanding the fiduciary requirements on trustees taking unpopular actions to correct plan funding issues can have political consequences for union trustees and union officials.

I believe we have to accept the reality that it will be very difficult for multi-employer plan boards to make necessary changes, particularly, for severely distressed plans. As multi-employer legislation is considered, serious consideration should be given to whether additional procedural or legal controls over the management of the plans could prevent serious funding issues.

Something as simple as imposing funding policy guidelines that mandate clear targets for the plan's unfunded liability. The Teamsters Western Pension Fund has long had a funding policy that established the funding levels and requires the trustees to adjust benefits. Plan modifications are virtually automatic. I see my red light is on so I will conclude.

[The prepared statement of Mr. Lynch follows:]

Statement of Timothy P. Lynch, President and CEO, Motor Freight Carriers Association, Washington, DC

Good morning. My name is Timothy Lynch and I am the President and CEO of the Motor Freight Carriers Association (MFCA). I want to begin by thanking Chairman Sam Johnson and the other members of the Subcommittee on Employer–Employee Relations for holding this hearing to discuss suggestions for securing the long-term viability of the multiemployer pension system.

I am here today as a representative of an association of trucking industry employers who by virtue of their collective bargaining agreement are major participants in a number of multiemployer plans. Their companies are key stakeholders in these funds. The employers I represent are concerned about the current framework for multiemployer plans and strongly believe that if not properly addressed, the problems will only get worse, thus jeopardizing the ability of contributing employers to finance the pension plans and ultimately putting at risk the pension benefits of their employees and retirees.

While we were supportive of the short-term relief provided to multiemployer plans under the recently-enacted Pension Funding Stability Act, we believed then, and continue to hold the view, that significant reform needs to occur if we are to secure the long-term viability of these plans. The financial difficulties facing the Central States pension fund are well known to this Committee, but Central States is not alone. Nor are the factors contributing to the problems of Central States unique. The challenges facing these pension funds cannot solely be attributed to the effects of a prolonged, down stock market. The problem, in our view, runs much deeper.

MOTOR FREIGHT CARRIERS ASSOCIATION

MFCA is a national trade association representing the interests of unionized, general freight truck companies. MFCA member companies employ approximately 60,000 Teamsters in three basic work functions: local pick-up and delivery drivers, over-the-road drivers and dockworkers. All MFCA member companies operate under the terms and conditions of the Teamsters union National Master Freight Agreement (NMFA), one of three national Teamster contracts in the transportation industry (the National Master United Parcel Service Agreement and the National Automotive Transport Agreement being the other two).

Through its TMI Division, MFCA was the bargaining agent for its member companies in contract negotiations with the Teamsters union for the current National Master Freight Agreement (April 1, 2003—March 31, 2008). Under that agreement, MFCA member companies will make contributions on behalf of their Teamster-represented employees to approximately 45 different health & welfare and pension funds. At the conclusion of the agreement, MFCA companies will be contributing $12.39 per hour per employee for combined health and pension benefits, or a 33% increase in benefit contributions from the previous contract. This is in addition to an annual wage increase.

DESCRIPTION OF PLANS

MFCA member companies, along with UPS, car-haul companies and food-related companies are typically the largest contributing employers into most Teamster/trucking industry-sponsored pension plans. The 45 Teamster/trucking industry benefit plans vary widely in size, geographic scope and number of covered employees. The two largest plans—the Central States Pension Fund and the Western Conference of Teamsters Pension Fund—have reported assets of $18 and $24 billion respectively and cover over 1 million active and retired employees in multiple states. Conversely, several smaller plans in the eastern portion of the United States have assets below $200 million and cover less than 1,200 active and retired employees.

As Taft–Hartley plans, these pension funds are jointly-trusteed (an equal number of labor and management trustees) and provide a defined benefit (although some plans offer a hybrid defined benefit/defined contribution program). MFCA member companies are represented as management trustees on most of the plans to which they make contributions. In an effort to help improve the management of the plans, MFCA member companies have made a concerted effort to nominate as management trustees individuals with backgrounds in finance, human resources, and employee benefits. However, because of the legal restrictions placed upon trustees in furtherance of their fiduciary responsibilities, there is very limited control by our companies over the actions and decisions of trustees. Additionally, there is no single appointing authority for management trustees but rather a mixture of associations and labor relations organizations.

RELATIONSHIP BETWEEN COLLECTIVE BARGAINING AND THE PENSION PLANS

In its report to this Committee, the General Accounting Office (GAO) reported that multiemployer plans "contribution levels are usually negotiated through the collective bargaining agreement" and that "[b]enefit levels are generally also fixed by the contract or by the plan trustees." In our case, that is only partially correct: the NMFA only establishes a contribution rate. It does not set a pension benefit level. It is worth reviewing for the Committee the relationship between collective bargaining and the multiemployer pension plans.

Like most multiemployer plans, our plans are maintained and funded pursuant to collective bargaining agreements. During each round of bargaining, the industry and union bargain and agree on the per-hour contribution rate required to be paid by employers to the plans for pension and health benefits. Once the rate is established, however, the role of the collective bargaining process and of the collective bargaining parties with respect to the plans—in terms of the level of benefits, the administration of delivering those benefits, management of plan assets, etc.—is over. For employers, the only continuing role in the plans is to make the required contractual contributions. That is, unless the plan, over which the employers have no control, runs into financial crisis. I will talk more about that in a moment.

Each multiemployer pension plan is a separate legal entity managed by an independent board of trustees. It is not a union fund controlled by the union. Nor is it an employer fund, over which the employer has control. Rather, by law, the plans are managed independently by their trustees under a complex set of statutory and regulatory requirements. Although the trustees are appointed - half by the union and half by the employer - each trustee has a legal obligation to act not in the interest of the union or employer that appointed them, but rather with a singular focus on the best interests of the plans participants. Trustees who do not act in the best interest of participants may be held personally liable for breach of their fiduciary duty.

As noted earlier, employers' role with respect to multiemployer pension plans is limited to making contributions unless the plan runs into financial difficulty. Under current law, employers are ultimately responsible for any funding deficiency that the multiemployer plan may encounter. Specifically, if a multiemployer plan hits a certain actuarially-calculated minimum funding level, employers in the fund are assessed a five percent excise tax and are required to pay for their pro-rata share of the funding shortfall or face a 100% excise tax on the deficiency. The requirement to make this payment of the shortfall effectively removes a key element of contract negotiations—employee benefits—from the collective bargaining process.

This framework is modeled after the single employer plans. With single employer plans, a company sets up a pension plan and the company is responsible if the plan becomes underfunded. But, the big difference between single employer plans and multiemployer plans in this context is that a company controls its plan—determines benefit levels—where as employers in multiemployer plans do not have that kind of control. Like other multiemployer contributing employers, MFCA companies find themselves with ultimate responsibility for the plans into which they contribute with no control over the fund's administration.

HOW WE GOT TO WHERE WE ARE

The year 1980 witnessed a defining moment in the history of the trucking industry. Or more accurately, two defining moments. In that year Congress passed two major legislative initiatives—the Motor Carrier Act (MCA) and the Multiemployer Pension Plan Amendments Act (MEPPA)—that radically altered the profile of the industry and the landscape for industry-sponsored pension plans. The first brought about deregulation of the trucking industry and all the associated market dislocations. The second upset the essential balance between exiting and entering employers that is key to maintaining a viable multiemployer pension program.

No one disputes the economic benefits to the American economy from deregulation of the trucking industry. Customers have more options, freight moves more efficiently and productively and total transportation/logistics costs have been reduced. But those benefits have not come without cost and part of those costs are associated with the departure of unionized truck companies as contributing employers to multiemployer pension plans.

To put this in some perspective, I have included in my statement (Appendix A), a list of the top 50 general freight, LTL carriers who were operating in 1979, the year just prior to enactment of MCA and MEPPA. Of those 50, only 7 are still in operation and only 5 of the 7 are unionized. Virtually all of the 43 truck companies no longer in business had unionized operations, and consequently were contributing employers to industry-sponsored pension plans. There have been no subsequent new

contributing employers of similar size to replace these departed companies. And beyond the top 50 there were literally hundreds, perhaps thousands, of smaller unionized truck operators who also have fallen by the wayside.

The dynamic of our economic system is the right to grow and flourish as well as the risk of failure and bankruptcy. Unfortunately, in the world of MEPPA we are no longer sure who really qualifies as the winner. Trucking companies fiercely compete in the marketplace but perversely have to hope their competitors don't go under. We have become not only our brother's keeper, but also the keeper of his pension liabilities. Or as the GAO report to this Committee described the situation:

> "Thus an employer's pension liabilities become a function not only of the employer's own performance but also the financial health of other employer plan sponsors.

The simple fact is that since 1980 there has not been a single trucking company of any significant size to replace any of the departed companies on the Top 50 list. Part of that can be explained by the overall trends in collective bargaining. But there can be no question that the risk attendant to withdrawal liability has proven to be a powerful disincentive for new employers to come into trucking industry plans.

Withdrawal liability clearly has been a barrier to new contributing employers coming into the funds but there's also strong evidence that it has not resulted in any significant recovery of liabilities of withdrawing employers, one of the key assumptions of the original MEPPA debate. One of the largest trucking industry plans reports that bankrupt (withdrawing) employers ultimately pay less than 15% of their unfunded liability. And what happens when these liabilities are not fully recovered? They become the responsibility of the remaining contributing employers.

Nothing highlights the inequity of this situation more than the recent bankruptcies of two contributing employers: Consolidated Freightways (CF) and Fleming Companies. Both companies were large, top 10 contributing employers to the Central States plan. They also sponsored their own company, single-employer plan. Last June, PBGC announced it was assuming responsibility for the CF plan with a potential liability of $276 million. On February 12, 2004 PBGC announced it was assuming the Fleming plan with a projected liability of $358 million. The combined liability for PBGC of the two companies' single employer plans will be $634 million.

Conversely, the Fleming and CF employees/retirees covered under multiemployer pension plans like Central States will now be the responsibility of the remaining contributing employers, less whatever these plans can recover in withdrawal liability payments. These beneficiaries will be entitled to a guaranteed full pension benefit. This will only add further cost to what is already one very stark financial fact of life for the Central States fund: half of its annual benefit payments now go to beneficiaries who no longer have a current contributing employer.

The problem of taking on the increasing pension liabilities of individuals who no longer have an active employer making contributions into the fund is further exacerbated by the demographic trends and increasing costs of other employee benefits. Before the decade is out, it is very likely that several large trucking industry plans will have two retirees for every one active. Without any significant new contributing employers, it is difficult to see that trend slowing down or reversing.

MEPPA delineates a very different role for PBGC with respect to single employer versus multiemployer plans. The GAO report identifies four: monitoring, providing technical assistance, facilitating activities such as plan mergers, and financing in the form of loans for insolvent plans. In contrast to PBGC's more aggressive role with single employer plans, these are relatively passive activities. It was not until the recent Congressional debate over whether to provide limited relief to multiemployer plans that attention was focused on the need to have a better understanding of the true financial condition of these plans. And underlying that need was a concern whether the relief would provide assistance for a truly short-term issue or mask a more fundamental, long-term problem.

Furthermore, the remedies available to multiemployer plans in the form of amortization relief or waivers are often viewed as "last resort" solutions. There are no intermediate steps that can assist a plan well before it reaches this point.

WHERE DO WE GO FROM HERE

The single most significant problem confronting multiemployer plans in the trucking industry is the declining number of new participants. The multiemployer concept is a workable model if there are sufficient contributions being made today to sustain payment of current benefits. And as we have seen with recent history, heavy reliance on investment income can leave plans vulnerable to the vagaries of the market.

However, the fact that there is a shrinking number of unionized trucking companies or that people are living longer are beyond the scope of what we are here to discuss today. There are simply some things we cannot change.

But, as indicated at the beginning of my statement, we believe there are changes that can be made and that reform of the MEPPA statute is both necessary and timely. To assist the Committee in developing its reform proposal, we would respectfully suggest that several key issues be addressed.

Withdrawal Liability

It is no secret that the current framework for collecting withdrawal liability is broken. It doesn't collect the unfunded liabilities it was designed to collect, leaving most multiemployer plans—and ultimately all other contributing employers in the plan—responsible for benefits of withdrawn employers. Additionally, as noted, withdrawal liability makes multiemployer plans very unattractive to new employers.

The number of unfunded participants—those whose employer has withdrawn from the fund and is no longer making contributions—has created such a significant burden at some plans that drastic action may be required.

We would recommend that Congress direct the PBGC to undertake a comprehensive study of the unfunded participant issue and the financial burden it poses on multiemployer plans. Obviously, plans and the contributing employers cannot survive long term if only a handful of viable truck companies are responsible for the last 50 years of trucking industry retirees.

There also needs to be some exploration of alternatives to withdrawal liability that maintain the integrity of the plans but remove the disincentive for potential new contributing employers. Among other things, serious consideration should be given to developing a "withdrawal formula" that will align benefits of employees of withdrawing employers to the amounts actually recovered.

Greater Multiemployer Plan Controls/Oversight

The basic structure of multiemployer plans makes plan design—and certainly benefit reduction—decisions very difficult. Notwithstanding the fiduciary requirements on trustees, taking unpopular actions to correct plan funding issues can have political consequences for union trustees and union officials. Notwithstanding the essential benefit modifications required at Central States last year, it took the trustees more than a year to agree on cuts, and they occurred only after the judge overseeing the Fund imposed them. I believe we have to accept the reality that it will be very difficult for multiemployer plan boards to make necessary changes particularly for severely distressed plans.

As multiemployer legislation is considered, serious consideration should be given to whether additional procedural or legal controls over the management of the plans could prevent serious funding issues. Something as simple as imposing funding policy guidelines that mandate clear targets for the plan's unfunded liability. The Teamsters Western Pension Fund has long had a funding policy that established the funding levels and requires the trustees to adjust benefits based on the levels. Plan modifications are virtually automatic.

Additionally, consideration should be given to requiring that the level of plan benefits be more closely tied to the level of plan contributions and available assets. This may require a hard look at anti-cutback provisions. If trustees want to increase benefits during good times, there should be less restriction on their ability to reduce benefits during bad times.

We also believe that there needs to be additional oversight and procedures to handle funds if they do develop funding problems. Consideration should be given to enhancing the PBGC monitoring function. It is helpful to have a "Watch List" but it's more important to have the ability to act on that "Watch List." The current PBGC program could be expanded to differentiate between plans that are financially healthy, not-so-healthy, and troubled. For those plans in the latter two categories, appropriate remedial steps should be taken to address the particular problems. There is no reason why multiemployer plans should not receive more attention from the PBGC.

Additionally, there should be a review of the procedures and conditions for granting amortization or waiver relief to determine if these provide appropriate solutions given the financial condition of the plan and that of the contributing employers.

Finally, we believe that consideration needs to be given to the development of fiduciary guidelines for trustees to facilitate the merger of plans. If two pension plans can cover 85% of the country, there is no reason why we need twenty to cover the remaining 15%. Yet, notwithstanding the best efforts of plan trustees to consider plan mergers, there remain issues of fiduciary responsibility that hinder this effort.

Correct the Imbalance of Employer Responsibility/Burden

MFCA believes there needs to be a comprehensive review of the relative roles and responsibilities as between contributing employers and multiemployer plans. Employers cannot be expected to bear ultimate responsibility for the financial viability of plans, but at the same time be precluded from any ability to hold the plan and its trustees accountable.

Finally, the excise tax on contributing employers must be eliminated. It is punitive and provides no benefit to the plan. It may provide some measure of accountability for single employer plans in which the employer controls both funding and decision-making, but not in the multiemployer world in which the employer has no control of the latter.

In conclusion, I want to once again thank the Subcommittee for its willingness to review the issue of multiemployer plans and to consider our views and suggestions on this matter. I am happy to answer any questions you may have.

TOP 50 LTL CARRIERS IN 1979

1. **Roadway Express**
2. Consolidated Freightways
3. **Yellow Freight System** (Yellow Transportation)
4. Ryder Truck Lines
5. McLean Trucking
6. PIE
7. Spector Freight System
8. Smith's Transfer
9. Transcon Lines
10. East Texas Motor Freight
11. Interstate Motor Freight
12. **Overnite Transportation**
13. **Arkansas Best Freight** (ABF Freight System)
14. American Freight System
15. Carolina Freight Carriers
16. Hall's Motor Transit
17. Mason & Dixon Lines
18. Lee Way Motor Freight
19. TIME-DC Inc.
20. Wilson Freight Co.
21. Preston Trucking Co.
22. IML Freight
23. Associated Truck Lines
24. **Central Freight Lines**
25. Jones Motor-Alleghany
26. Gateway Transportation
27. Bowman Transportation
28. Delta Lines
29. Garrett Freightlines
30. Branch Motor Express
31. Red Ball Motor Freight
32. Pilot Freight Carriers
33. Illinois-California Exp.
34. Pacific Motor Trucking
35. **Central Transport**
36. Brown Transport
37. St. Johnsbury Trucking
38. Commercial Lovelace
39. Gordons Transports
40. CW Transport
41. Johnson Motor Lines
42. System 99
43. Thurston Motor Lines
44. **Watkins Motor Lines**
45. Santa Fe Trail Transportation
46. Jones Truck Lines
47. Merchants Fast Motor Lines
48. Murphy Motor Freight
49. Maislin Transport
50. Motor Freight Express

Bold = Still Operating on 4/1/04

Chairman JOHNSON. Thank you, sir. I appreciate your testimony. You certainly may submit the rest of it for the record.

Mr. LYNCH. Thank you very much.

Chairman JOHNSON. I recognize the gentleman next to you. What do you want me to call you? Rocky?

Mr. MILLER. Rocky is fine.

Chairman JOHNSON. Thank you, sir. You're recognized.

STATEMENT OF JOHN S. (ROCKY) MILLER, JR., PARTNER, COX, CASTLE & NICHOLSON, LLP, LOS ANGELES, CA

Mr. MILLER. Thank you, Mr. Chairman, Ranking Member Andrews and Committee members. It is a privilege to appear in front of you today. I have submitted written remarks that I won't repeat.

I have essentially suggested three items for consideration by the Committee in considering multi-employer reform, and the first is to tinker with care. The multi-employer defined benefit pension plan system is a very different animal than the single-employer system, and it needs to be recognized as such and treated as such.

The second suggestion is that the Deficit Reduction Act funding limitations for multi-employer plans be forever removed or at least removed permanently to see how it operates prospectively. We do not believe that there are the same potential for tax avoidance in a multi-employer system that there is in the single-employer system, because once a multi-employer employer contributes to that multi-employer plan, contributions—those contributions are gone from that employer. And while the small employers who contribute to multi-employer plans do so to provide a superior benefit than they could do individually, they do not want to provide an excessive benefit.

So to have a funding limitation, is not necessary for multi-employer plans and, unfortunately, the existence of the deficit reduction act contribution limitation is, in fact, the reason that the multi-employer system is in front of you for reform today. Because it more than anything caused the under funding that we are seeing.

All plans that I am aware of reached full funding at the late '90's and began having to improve benefits on a permanent basis or take other steps to stop funding in order to avoid becoming over funded. And, of course, we all knew as that was done that we were at the end of our historic bull market, and we were going to regress to a 7 1/2 percent ongoing rate of return.

So it was crazy to have to stop funding at that point, and most of the plans have had a predictable 25 percent downturn in their funding status, which would not have happened but for that limitation.

And then the next point is that we need to find a way that is designed for multi-employer plans to encourage the plans to have a minimum funding level so that we can get the funding above a full funding point and insure that it will—that inbound turns it will not drop below full funding point or an appropriate funding point.

However, that is a difficult concept to impose. For example, the suggestion of a 90 percent funding level and there would be no benefit improvements if you're below that level, I don't believe that is a workable rule, because in a collectively bargained system, which is a voluntary system, the employees, the union, and the employers all have to believe in the plan to work together to keep it appropriately functioning.

And if you cease improving benefits in the collective bargaining process, it reduces the employee willingness to stick with the plan. Their demands will go elsewhere. They'll go to other benefits and to wages, and that defeats the employer's ability to over fund the

plan. So the experience that we have is that you can get over funding—appropriate over funding of multi-employer plans if you negotiate for it, and part of that negotiation process has to be to incrementally allow benefit improvements.

I have not seen a proposal yet that deals with how to address this problem. I think it is one that needs to be studied. One of the ways that it has practically been addressed in negotiations is to price benefit improvements over the life of the collective bargaining agreement, and in terms of the package that the employers are putting on the table of "X" dollar an hour, if the union wants a benefit improvement of a certain type, actuarily what is the cost of that over the life of the agreement. And you can come—that has worked pretty well in Southern California. So I see my time is up and I will cease.

[The prepared statement of Mr. Miller follows:]

Statement of John S. (Rocky) Miller, Jr., Partner, Cox, Castle & Nicholson LLP, Los Angeles, CA

Mr. Chairman and members of the Committee, it is a privilege to appear before you to discuss the Multiemployer Pension Plan system. I am speaking on my own behalf and as a member of Cox, Castle & Nicholson LLP.

I. Background

Cox, Castle & Nicholson is a full service law firm for the real estate and construction industry that has been continuously involved in multiemployer plans from their inception in the mid–1950's. For over 50 years, it has been counsel to the Associated General Contractors of California. Throughout that time, it has been involved in assisting AGC, other multiemployer associations and individual employers in their negotiations of labor agreements with construction industry and other unions. In the 1950s and 1960s, Cox, Castle & Nicholson helped create many of the multiemployer benefit plans negotiated in Southern California. It then served as management co-counsel to many of those plans.

I have been involved in multiemployer benefit plan issues and in management-side labor relations my entire career. I began practicing law with Cox, Castle & Nicholson just as ERISA had become applicable to multiemployer benefit plans. I have represented multiemployer associations, individual employers, and the boards of trustees of multiemployer benefit plans of all types in all of the various legal matters they encounter. For almost 25 years, I have participated on behalf of employers in industry-wide multiemployer labor negotiations and in single employer labor negotiations, all of which have involved benefit plan issues. On behalf of multiemployer pension plans, I have been privileged to defend before the U.S. Supreme Court the constitutionality of the Multiemployer Pension Plan Amendments Act of 1980 upholding the construction industry withdrawal liability rule. Conversely, on behalf of the owners of a shop employer, I was fortunate to obtain the only injunction issued by a District Court barring on constitutional grounds the retroactive application of the Multiemployer Pension Plan Amendments Act of 1980 withdrawal liability to a non-construction industry employer. I have also been honored to serve as a member of the ERISA Advisory Council of the U.S. Department of Labor, and I am an employer-side director of the National Coordinating Committee for Multiemployer Plans and a district director of the Associated General Contractors of California.

II. Multiemployer Plans Are Worth Preserving

Multiemployer benefit plans enable tens of thousands of mostly small employers to provide retirement, medical and other benefits to millions of their employees. The benefits provided are of a significantly better quality than these employers would ever have been able or willing to provide individually.

The small employers that I have encountered over the years in construction industry multiemployer plans have a strong and uniform desire to provide quality retirement and medical benefits to their good employees, provided that the employers can still be competitive and profitable in the process. Employers who participate in multiemployer plans face competition day-in and day-out from employers who provide either no benefits or minuscule benefits to their employees. Employers who contribute to construction industry multiemployer plans must be more efficient, better

organized and more sophisticated in order to survive and to stay competitive. A key part of that is having access to the best-trained and most productive employees.

These small employers make a choice each time labor negotiations recur, typically every three to five years, whether to continue to "be union" and bound to collective bargaining rules and multiemployer benefit plan obligations or whether to opt out of a multiemployer bargaining group in order to abandon those burdens and compete unimpeded. In negotiations over the last ten to fifteen years in Southern California, comparatively few employers have chosen to leave. Those that wanted to, by and large, got out long ago.

Instead, these employers remain and negotiate aggressively on a combined basis to maintain their competitiveness and profitability while finding some common ground with the unions representing their employees that protects and often improves incrementally the employees' living standard contract after contract. This negotiation continues in a more collaborative sense as management trustees sit across from labor trustees and jointly-manage their multiemployer benefit plans. Benefit levels are adjusted by mutual agreement with the aid of sophisticated actuarial calculations and advice. In many settings, benefit improvements approved by labor and management trustees must also be agreed upon by the multiemployer associations and the union that sponsor the benefit plan in question.

By this process, thousands of small construction employers in Southern California throughout the last forty years have provided the employees who worked for them and for their predecessors and competitors in the 30s, 40s and 50s, before multiemployer pension plans were even established, with high-quality retirement benefits paid for out of contributions made on hours worked by current employees. These small employers agreed with their unions to act in the same manner as Congress determined to act when adopting Social Security, finding that those who worked before the plans were created and who had paid nothing toward a pension benefit were still deserving of a benefit. These employers, the unions and their members, mutually agreed that money that might otherwise go toward a pension for the hour worked by a particular employee would instead go to the generation that preceded him or her. This Social Security-style transfer of income continues by mutual agreement but to a declining degree. To this day, retirees in many multiemployer plans who worked in the early years of those plans when hourly contributions were $0.05, $0.10 or $0.25 an hour, are receiving pension benefits for those years of service that significantly exceed the income that could have been generated off of those contributions. At the same time, the small employers acting through their multiemployer associations have worked with the unions and their employees to fully fund their pension plans in order to ensure that the hours currently worked by employees could be rewarded upon retirement by payment of the full pension benefit promised for that hour of service.

Today, these employers and their unions are facing the sudden underfunding of their promised benefits as a consequence of the downturn in the markets and the decline in interest rates to historic lows. But, the multiemployer bargaining groups are already addressing this underfunding with their unions at the bargaining table as each multiemployer labor agreement comes up for renegotiation. Recent multiemployer labor agreement settlements have dedicated almost all compensation increases to re-funding pension plans and to maintaining healthcare plans. Yet, the average annual percentage cost increase reflected in such labor agreements has not increased materially beyond the settlements that were occurring before the downturns. Employees are willingly foregoing wage increases to protect benefit levels. This reflects the importance of these multiemployer plan benefits to the employees of these small employers and the simultaneous willingness of the unions and their members to keep their employers competitive with employers who do not provide such benefits.

This conduct is, in effect, a voluntary increase by employees of their savings rate at the expense of their take-home pay. This is conduct Congress has tried to promote for twenty years or more with no success. Yet, over that same twenty-year period and continuing today, employers, their employees and unions involved in multiemployer negotiations have been practicing what Congress has preached.

This is a benefit system that works. The participants in it, on the whole, have received greater benefits from it than other employees have received from individual employers. It should be facilitated and strengthened.

III. Congress Giveth And Congress Taketh Away

The success of multiemployer plans is attributable to Congress. The severity of today's under-funding problem is also attributable to Congress.

A. The Good

Multiemployer plans exist and have been successful because of Congress. Through various legislation in the 1930s and earlier, Congress took steps to exempt employers and unions from antitrust and conspiracy laws to permit unions to organize and to permit employers to combine together and negotiate with unions. In the Taft–Hartley Act in 1947, Congress authorized the creation of multiemployer benefit plans, provided that employers and unions managed them jointly. In 1959, in the Landrum Griffin Act, Congress redressed certain abuses that were occurring in such plans. In 1974 in ERISA, Congress imposed funding requirements and other constraints on multiemployer plans to ensure that promised benefits would be there when participants reached retirement. In 1980, in the MPPAA, Congress imposed upon employers in a multiemployer plan the financial obligation to make good on the pensions promised by that plan. This financial discipline was imposed by the concept of "withdrawal liability : an employer withdrawing from a multiemployer pension plan must pay to the plan that employer's respective share of the unfunded vested pension liabilities of that pension plan. Further, Congress imposed financial liability on all contributing employers in a multiemployer plan to fund unfunded benefits should the plan terminate in an underfunded status.

These various Congressional enactments have taken a multiemployer plan system created among private parties and managed, maintained and grown by the day-to-day decisions of small employers and their unions and have channeled those private actions to ensure that all multiemployer plans reached proper levels of funding and were managed in an appropriate manner along the way. Congress' actions were a success. By the end of the 1990s, the overwhelming number of multiemployer pension plans were essentially fully funded.

B. The Bad

Unfortunately, Congress also subjected multiemployer plans to the Deficit Reduction Act. This well-meaning Congressional enactment imposed upon multiemployer pension plans a full-funding limitation. Actuarially, the maximum level to which a multiemployer plan could be funded was approximately 110% of liabilities. Most plans hit this ceiling at the end of the 1990s. At that time, all multiemployer plan trustees knew that the bull market in stocks had lasted a very long time. If actuarial use of a 7.5% or so expected long-term investment rate of return had any validity at all, rates of return in the markets had to revert to the mean and were likely to do so sooner rather than later. Nevertheless, to prevent employer contributions from becoming non-deductible under the Deficit Reduction Act, either pension benefits had to be raised or employee contributions had to be cut.

Throughout the country, multiemployer plans improved benefits. They did not do so inappropriately. The benefit improvements were warranted for the participants that would receive them. And, in many cases, employer contributions were also reduced, usually to be diverted to wages or medical benefit plans, but not always. In competitive markets, contributions were not infrequently reduced without diversion to other employee costs.

The problem of these actions was in the timing compelled by the Deficit Reduction Act. The benefit increases raised plan liabilities and decreased the cushion of overfunding available to withstand a reversion to the mean in investment returns. Absent the artificial funding ceiling of the Deficit Reduction Act, benefit improvements would have been agreed upon in smaller amounts spaced over a longer period of time. Employers, unions and both labor and management trustees would have continued to increase the "overfunded" levels of their plans in anticipation of a certain stock market downturn.

Naturally, just as most of these Deficit Reduction Act benefit improvements and contribution reductions had gone into effect, investment returns did begin regressing to the mean. Many multiemployer plans fell from full funding status to funding levels between 70% and 75% within these years. Some fell lower.

C. The Ugly

Then, in the depths of an investment downturn that will one day cycle back up as surely as it was due to cycle down, some multiemployer plan trustees and the employers and unions that sponsor them discovered another crisis. Their plans are facing minimum contribution obligations under the funding standards of ERISA. The prospect exists that some of these plans will have to assess the employers that participate in these plans extra contributions. In theory, these can be imposed in the middle of the term of a collective bargaining agreement without the agreement of the employers. Thus, an employer group that perhaps risked a strike to persuade their employees that the employers could not afford a penny more in labor cost is

suddenly at risk of being told that they may each owe a dollar an hour extra to "heal" the multiemployer pension plan.

Obviously, if any such impositions occur, the multiemployer plans that are involved may well be forever terminated by the employers as soon as possible. And other multiemployer plans will become less acceptable to small employers because of the perceived risk of contribution obligations being imposed over and above the wage and benefit costs agreed to in collective bargaining. For small employers who have been responsible in their participation in the management of multiemployer plans, such an outcome, based on an investment cycle downturn, is simply incomprehensible. It is one thing to tie one's economic fortunes to the unknowns of union negotiations. It is quite another to tie one's fortunes both to that unknown and to the unknowns of Congressional formulas that can produce surprise, immediate, extra cost impacts based on temporary conditions.

D. The Aftermath

Congress has identified the problem of the Deficit Reduction Act and provided in EGTRRA a temporary relaxation in the funding formula applicable to multiemployer plans. However, it is too little, too late. It will be years before any multiemployer plan is able to take advantage of the temporarily relaxed funding rules. In mature pension plans where a portion of plan income every year is spent on current pension benefit payments, a projected actuarial rate of return of 7.5% may only leave a return of 4% or less to rebuild plan funding levels. When an economic downturn has reduced funding levels by 25%, funding levels are rebuilt slowly.

Thus, the much more immediate problem for some multiemployer plans is the minimum contribution obligation. Congress was asked to assist the multiemployer plan community in the temporary relief legislation. Early reports on the relief that was granted suggest that it was so narrowly drafted that it will assist almost no plans. Yet, numerous plans are reportedly in need of temporary help and are plans that can likely return to full funding and prosperity if the collective bargaining parties and the trustees of the plan are simply afforded some time in which to re-fund the plan in a prudent manner.

IV. Multiemployer Plan Funding, Disclosure and Security—Suggestions for Reform

A. Tinker with Care

As the Deficit Reduction Act has demonstrated, the multiemployer plan system can be damaged and endangered by well-meaning Congressional action. The damage, once imposed, can take years to repair.

Multiemployer plans are complex. They represent a cost and risk to small employers that can easily become unacceptable if their cost is not predictable or if adequate time does not exist to address cost increases and other problems incrementally and through a series of scheduled collective bargaining negotiations.

The reasons employers contribute to multiemployer plans and the consequences of their contributions are different from some of the reasons employers have in contributing to single employer plans. Consequently, "improvements" to multiemployer plan regulation should be carefully studied in advance and supported by the multiemployer associations and unions that must live with the consequences of the regulation.

Congressional respect and appreciation should be given to the employers who voluntarily assume the economic burdens of a multiemployer plan to guarantee benefits for their own employees and for the other participants in a plan. This respect should permit greater recognition that multiemployer plans are, indeed, different than other plans and should be treated as such. This respect should also produce a recognition that, when multiemployer plans encounter difficult times, the parties to those plans have a significant incentive among themselves to solve those problems in a mutually agreeable manner and to restore the health of the plans.

The PBGC was mightily worried in the early days of ERISA that multiemployer plans in declining industries would impose dramatic funding obligations on the PBGC. Had Congress not modified ERISA appropriately, it is not inconceivable that the sky might have fallen. However, Congress acted carefully and incentivised employers and unions to solve the underfunding problems that existed early in the life of the nation's multiemployer plans. Over the twenty years that followed the passage of ERISA, the employers contributing to multiemployer plans funded those plans fully in almost all respects.

Respect should also prompt caution. Claims that multiemployer plans are unstable in competitive markets or in declining industries should not be accepted without the input of the entire community of employers contributing to multiemployer plans. Further, they should not be accepted without study of those plans that have contin-

ued to exist in declining industries and the lessons they may provide. Multiemployer plans in the mining industry and plans of the ILGWU have suffered dramatic losses of contributing employers and of hours on which contributions are received. Yet, reports suggest that these funds have survived to pay promised benefits to the participants in them.

In sum, much about the multiemployer plan system "ain't broke" and shouldn't be "fixed."

B. Remove the Deficit Reduction Act Funding Limitations from Multiemployer Plans on a Permanent Basis

Employers contributing to multiemployer plans should be allowed to overfund those plans without limitation to ensure that promised benefits can be provided even if economic downturns, declining industry conditions or departure of other contributing employers impair the current and future prospects of the plan. This is protective of the PBGC. Yet, it is not likely to be detrimental to the Treasury. Employers contributing to multiemployer plans do not have an incentive to overfund those plans to any greater degree than is prudent for the health of the plans.

Employers contributing to single-employer plans are different. They have a tax incentive to shelter income through the tax deductibility of contributions to the plan. Past behavior demonstrated these incentives as single employers used a variety of actions to overfund plans and then regain control of the excess assets.

In multiemployer plans, once an employer makes a contribution to the pension plan, it is, for all intents and purposes, gone from that employer's pocket. It will be used, one way or another, to the benefit of the employee participants in the plan. It will not revert to the employer.

The only way a contributing employer can gain an advantage from an excess contribution to a multiemployer plan is, in theory, to obtain a reduced obligation to contribute at some point in the future. However, obtaining such a benefit requires the agreement of the union and its members and of all the other contributing employers.

What actually happens with multiemployer plans is that excess contributions are usually converted to increased pension benefits somewhere along the way. If employers are granted reduced contributions by the union at a future date, it is likely to be in exchange for diversion of that contribution to wages or medical coverage. In rare cases, it could be to help reduce the employers' costs and keep them competitive.

Nonetheless, all of the foregoing outcomes are non-abusive, appropriate adjustments of economic conditions among private parties. None warrant imposition of funding limitations.

Most fundamentally, while employers may want to provide a good retirement benefit to their employees; they never want to provide an excessive retirement benefit. Thus, the employer groups participating in multiemployer plans are very unlikely to over-contribute to those plans.

Whether a multiemployer group concludes that a funding level of 120% or 150% of promised benefits or even higher is an appropriate target to insulate the plan from the risks of changing economic conditions, Congress should not be concerned. Indeed, at this point, such overfunding of multiemployer plans by multiemployer groups, given the current economic circumstances of plans, is unlikely to occur within this decade.

Congress should applaud overfunding by multiemployer groups rather than being concerned about imposing a ceiling. The more well-funded a plan is, the less likely it will ever be a burden to the PBGC, or the taxpayer or the participating employers remaining within the plan even if the employment in the industry in which the plan exists disappears overnight.

C. Mature Multiemployer Pension Plans Need to be Encouraged by an Appropriately–Designed Set of Incentives to Become Overfunded and to Ensure that Funding Levels Thereafter will not Drop Below an Appropriate Minimum Funding Level

Employers contributing to multiemployer plans would like to know, in theory, that their plans are overfunded and that these plans will not drop below a fully funded level no matter how severe economic conditions may become. The problem is how to achieve such a result.

For example, to say simply that a plan must remain more than 90% funded is to impose a rule that cannot be met for years to come and that will cause dislocations in collective bargaining conduct and disincentives among employees to the continued retention of the multiemployer pension plan benefit. Full funding in a collective bargaining setting is achieved incrementally. As is illustrated in the appendix which follows these suggestions, unions and union members will trade small benefit

improvements for a commitment to increased funding levels, but it becomes very difficult for them to agree that no benefit improvements will ever be adopted unless and until a funding level is exceeded. If they face such a restriction on their negotiating ability, they may well divert their demands to other benefits impairing the ability of the employer group to achieve and maintain full funding of a defined benefit pension plan. On the other hand, if a minimum funding limitation is developed that permits the negotiation process to trade off appropriate improvements here and there in exchange for a program of overfunding a pension plan and maintaining it above a minimum threshold, the multiemployer pension plan system is encouraged and protected rather than destabilized.

No set of incentives for minimum funding has yet been surfaced that would appear to strike the right balance. It may prove to be an elusive concept. However, it is worth studying. One starting point would be to challenge the actuarial community to bring forth some concepts to address this issue.

D. Revisit the Minimum Contribution Requirement for Multiemployer Plans to Address the Temporary Problems of Existing Plans and to Ensure that the Contribution Formula Is Appropriate for the Future

Mandatory contributions imposed outside the collective bargaining cycle are destructive of multiemployer plans and the multiemployer plan system. Funding rules must be sufficiently stable and predictable that collective bargaining parties can deal with the rules in the regular collective bargaining cycle.

For this immediate period of time, where the Deficit Reduction Act has contributed to the current underfunding of multiemployer plans, particular care should be given to whether or not those plans facing minimum funding standard deficiencies should be given greater leeway to recover from their economic circumstances.

CONCLUSION.

Many other issues can be raised and suggestions advanced for inclusion in a long-term reform package for multiemployer plan regulation. However, I will not suggest any further points here in these prepared remarks as they may serve to detract attention from the more important reforms and reform process suggested above.

I have attached one further comment as an appendix to these remarks. It is a brief illustration of how four construction industry multiemployer plans in Southern California were created, developed and managed under the changing regulatory and economic environment. Each plan and the union and employers that sponsored it have behaved differently, yet each plan has prospered and suffered quite similarly under Congress' enactments and under the economic and competitive conditions surrounding it. Together, the experiences of these plans demonstrate their importance to the sponsoring employers and their employees and the inherent stability and promise these plans retain for providing an appropriate mechanism for delivering pension benefits.

I appreciate very much the opportunity to appear before you. I would be pleased to assist the Committee further in any way it desires. And I look forward to responding to any questions you may have. Thank you.

APPENDIX

COMMENT—THE CONSTRUCTION INDUSTRY MULTIEMPLOYER PENSION PLANS OF THE BASIC TRADES IN SOUTHERN CALIFORNIA PROVIDE A GOOD EXAMPLE OF HOW CONGRESSIONAL ACTION HAS BENEFITED AND BURDENED THE MULTIEMPLOYER PENSION PLAN SYSTEM AND OF THE STABILITY AND VALUE OF THESE PLANS TO SMALL EMPLOYERS AND THEIR EMPLOYEES

The value of multiemployer plans and the impact of Congressional action upon them, both beneficially and detrimentally, is well-illustrated by the experience of the multiemployer pension plans in Southern California of the "Basic Trades", the Carpenters, Laborers, Operating Engineers and Cement Masons. In particular, the experience of these multiemployer plans demonstrates the responsible and varied conduct of the employers and unions that sponsor multiemployer plans and of the management and labor trustees that jointly manage such plans.

These plans were all created in the early 1960's. They were each created through master labor agreements between and among the four trade associations of general contractors and the councils and locals of the four unions in Southern California. The hourly contribution into the plans was minimal at first, a nickel or a dime an hour. Nevertheless, each of the plans began providing pension benefits almost immediately to those who had worked a sufficient number of years in the industry prior to the creation of the plan to qualify for coverage. Essentially, 15 years of serv-

ice was required. When ERISA was implemented by the plans in 1976, each of the plans retained their 15 year benefit programs and added a 10 year "ERISA plan" that satisfied the minimum requirements of ERISA.

After ERISA was adopted, the employer associations objected vehemently to ERISA's definition of a "defined contribution" plan. The employer groups all had negotiated with each union express understandings that the employers' only obligation to the pension plan was the hourly contribution. ERISA appeared to impose greater liability on the employers. This debate continued, in California and around the country, until the adoption of the MPPAA in 1980. The MPPAA clarified that employers contributing to multiemployer plans were, in fact, liable for their share of the unfunded vested liabilities of a pension plan. At the time the MPPAA went into effect, one of the four plans was only 25% funded. All had substantial unfunded liabilities exceeding $300 million for each of the three large plans. Employers who considered leaving these plans and incurring withdrawal liability were looking at acquiring $30–50,000 of liability for each full-time employee equivalent per year over a 5-year "look-back" period.

Beginning in 1980, through collective bargaining, the employers and each of the unions agreed that pension benefits would not be raised again without substantial progress being made toward funding the plan. At a minimum, the employers and each union agreed that sufficient contributions would be directed to the pension plan to reduce the actuary's estimated time necessary to fund the plan by one year for each year that passed. At the time withdrawal liability was imposed, the expected amortization periods mostly exceeded 20 years.

During the 1980's, the employers and each union gradually but substantially increased the rate of contribution to each pension plan. All agreed that pension benefits would not be increased except for the occasional adjustment here and there to address specific problems of particular groups.

By the late 1980's, two of the plans approached full funding. From that time on, one union agreed with the employers to freeze its defined benefit plan and to create a defined contribution plan into which all future contributions would flow. The other union and the employers continued to fund its defined benefit plan, improving benefits somewhat, but building a reserve beyond full funding.

By the early 1990's, the third multiemployer plan began to approach full funding. The employers and the union for this plan had been following a process of increasing benefits by one to two dollars per credit per year if the actuary concluded contemporaneously that sufficient actuarial "margin" existed to reduce the amortization period by the required amount and still fund the credit increase. As full funding was approached, the one and two dollar per credit increases were negotiated to occur more often and a practice was begun of issuing "13th checks" for existing retirees. Sometimes during the course of the year, this plan would issue three "13th checks". Each would equal one month's pension benefit.

The fourth plan did not fully fund until about the mid–1990s. This was because the employers and the union sponsoring this plan made a conscious decision to boost benefit levels significantly for all participants including all retirees in the early years of the pension plan. As a consequence, once withdrawal liability was created, benefits remained static for all plan participants for approximately fifteen years until full funding was achieved.

After full funding was achieved by this plan, the employers negotiated to overfund this plan to the maximum extent permitted under the Deficient Reduction Act. The union agreed with this in concept, but insisted on benefit improvements for more recent retirees and participants to adjust their comparative under-receipt of benefits over the years that benefits had been frozen. This was accomplished in each of several successive labor negotiations by negotiating benefit improvements at the bargaining table. Actuarial projections were used estimating the amount of contributions needed to pay for each benefit improvement on either a fifteen-year amortization in some instances or, more typically, on a three-year amortization to permit full-funding of the benefit improvement over the life of the master labor agreement.

The other plan that had continued to overfund achieved maximum overfunding in the mid–1990's. Thereafter, the employers and this union agreed with the trustees to improve benefits dramatically for employees currently working for employers. Actuarially, these benefit improvements were calculated to insure that only enough were given to keep the plan within funding limits. This plan also provided some 13th checks to existing retirees.

The plan that had been frozen in favor of a defined contribution plan was reopened and resuscitated in the 1990's. The employers, the union and the participants in the plan collectively decided that the defined contribution plan was not of as much value as the defined benefit plan. The result is that both plans are maintained on an ongoing basis.

The plan that was increasing benefit credits by one or two dollars per year and paying 13th checks has continued on a similar course. The effect of this plan's benefit payments has been to maintain the plan just under full funding limits.

After the collapse of the stock market and the unprecedented decline in interest rates, all of these plans dropped from fully funded or close to fully funded status to funding levels around 75%. In each case, the employers, the union and the plan have reacted.

The trustees of the most overfunded pension plan immediately reduced the value of benefit credit earned for future benefit accruals in recognition of the declining economic fortunes of the plan. The practice of this plan and of the employers and union involved has been to move quickly in adjusting benefit levels and then to retroactively increase benefit levels when financial circumstances permit. Thus, the expectation is that these reduced levels of future benefit accruals will one day be restored when funding is back to desired levels.

The plan that made a practice of increasing benefit credits dollar by dollar and of giving numerous 13th checks has ceased those enhancements. Collective bargaining will occur later this year and further address the funding issues.

The remaining two plans were subject to master labor agreements that have been recently renegotiated. In the negotiation of these agreements, the employers requested and the unions agreed to invest almost the entire amount of the wage and benefit increases negotiated into the defined benefit pension plans and into the medical multiemployer benefit plans. In negotiating these contribution increases, the collective bargaining parties looked at 5-year projections by the actuary of funding levels and the extent to which funding levels were likely to remain low or even deteriorate further unless substantial action was taken. Substantial action was taken.

Projecting forward, all of the four unions agree with the employer associations that full funding is important to the safety of the plans and to keeping employers comfortable that they will not acquire unexpected pension liabilities beyond the amounts of their hourly pension contribution by participating in these multiemployer pension benefit plans. The boards of trustees of each of these multiemployer pension plans has long been populated by employer representatives and union representatives who get along well and work cooperatively to manage the plans. All of these boards of trustees coordinate with their respective employer associations and union leadership to be certain that the actions taken by the trustees are acceptable to the employer associations and to the union leadership as a whole. Three of these unions have been aggressive for more than a decade in negotiating competitive terms and conditions with the employer associations to recognize the competition these employers face from contractors that have no union obligations and that provide few or no fringe benefits to their employees.

These circumstances have kept employers participating in these four plans with little fear of serious adverse consequences.

Chairman JOHNSON. Thank you, sir. I appreciate your comments. Can I call you Dr. Teresa?

Dr. GHILARDUCCI. Yes.

Chairman JOHNSON. You're recognized now. Thank you. Microphone, please.

STATEMENT OF TERESA GHILARDUCCI, PH.D., FACULTY OF ECONOMICS, UNIVERSITY OF NOTRE DAME, NOTRE DAME, IN

Dr. GHILARDUCCI. There's some new research from health and labor economists that may help us all—folks in back of me and the colleagues that couldn't be here today—that actually puts a new spin on this whole idea that we're living longer. One of the reasons we're living longer is because people are retiring.

It looks as though that people being able to rest from their long career of work is actually letting them invest more in their health and actually improve their health. This is especially true for women, but it's also true for men. No matter what kind of job they have, white or blue collar, this is really exciting new research, and it comes from the new data from the University of Michigan.

And saying that, we must then realize how important it is to get pensions, because we try to solve the pension problem by raising retirement age, thinking that people living longer anyway raising the retirement age and taking away pensions may actually reduce that longevity we so herald.

So with that, we are here again today as a group of people who have been really worried about expanding pension coverage. And, especially, expanding pension coverage among low-income workers. And multi-employer plans is really a high-performance model of how to do that. So you can—and you've seen previous testimony that showed that multi-employer plans actually exist for workers who are mobile, especially, work in small to medium-size establishments.

But I'm here to talk about how multi-employer plans really help the employers. They solve a classic public good problem. That employers want trained, skilled workers, but don't want to pay for it unless their competitors pay for it. So by coordinating with their competitors, they pitch in with an apprenticeship program, health program, and a pension program. They all have a piece. They all come together. And this actually helps industries produce skilled workers, stabilize industries, and it's really good for the economy.

I have documents on how high performance these plans are for the economy. I don't want to talk about them right now. I'd like to submit those for the record.

Chairman JOHNSON. Please do.

Dr. GHILARDUCCI. Now, I'd like to actually talk about some of the reforms—the specific reforms that you have addressed here. We must know that one of the chief and brilliant aspects of multi-employer plans is that they are jointly trusteed by an employer group and an employee group. And this brilliance, this wisdom means that they are highly adaptable to their specific situation.

It actually gives a break to Congress. You don't have to legislate in every industry and every region. The trust agreement and the collective bargaining agreement and the relations between employer and employee lets that regulation happen. That's why any rule that says it is 90 percent funded, there should be no benefit increases makes really no sense when you look at the whole economic logic of these things. So don't do that. There's no need to restrict benefits.

As far as withdrawal liability, I wrote a book several years ago interviewing most employers and employees on multi-employer plans, and I was really struck with how they've used withdrawal liability. If there, indeed, is a crisis in some plans because too many employers left, guess what the drastic solution is? To get more employers into the plan. The employers and the unions will have a reason to do that if the withdrawal liability is too great or if they're funding too many people who aren't contributing.

In Las Vegas auto shops are now organizing into a pension plan and to a health plan in a way they never did before under multi-employer plan agreement, because they're good deals. If auto shops in Las Vegas can do it, then other multi-employer plans surely will find a way to expand. So tinkering with the withdrawal liability would really have these unintended consequences on these long-term agreements.

The other point I want to make is—has been agreed upon—you were right—Mr. Andrews was right. This is really non-partisan. We should have pension rules that let people accumulate funds in good times, so that when there are bad times they can draw on it. So we should raise those deductibility limits or eliminate them completely for multi-employer plans.

But I'm here as a professor, and I'd like to offer some blue-sky ideas, ideas that representatives through organizations might not be able to. One is an idea that actually has been played around here, and that is to allow employees to contribute to defined benefit plans. And multi-employer plans it's probably a little bit easier to do that, because you have defined contributions coming in, but, actually, feedback on employees' defined benefits. So multi-employer plans are actually structured to let employees contribute. That's a great idea.

We should also find ways to encourage the creation of defined benefit plans. When I was at the PBGC, we always explained the conversion from DC to DB is because the vendors sell 401K plans. There's profits to be made there but not enough vendors sell DC plans.

Last, we should investigate the consultant industry for how they got us into this what's been called—and I think inaccurately—the Perfect Storm of low interest rates and high—well, low interest rates and low returns. The consultants told us—and I was a trustee on the Indiana Public Employee Relations Funds—told us that we would have high stock returns as far as the eye could see, and, therefore, we should load up our funds.

Well, they weren't being prudent. That industry needs some accountability and needs some investigation. The SEC is doing it now, and I think it's—I think Congress and this Committee would be well served to show that this Perfect Storm wasn't an act of God and unpredictable. It wasn't a quirky incidence. It was built into the structure of pension fund consulting.

[The prepared statement of Dr. Ghilarducci follows:]

Statement of Teresa Ghilarducci, Ph.D., Faculty of Economics, University of Notre Dame, Notre Dame, IN

Mr. Chairman and members of the Committee, thank you for this opportunity to meet with you and discuss ways to improve America's defined benefit pension system.

We all know pension policy is stymied by our failure to extend pension coverage to workers who change jobs frequently, work for smallish employers, and whose employer changes because of mergers and acquisitions.[1] Yet some workers in this category have secure portable, defined benefit pensions; approximately twenty two percent of DB covered participants are in multiemployer plans which are risk-pooling,

[1] Multiemployer plans also help employees who stay in the same job but their owners are unstable. For two decades, nurses employed in a New Jersey hospital bargained to be included in the multiemployer pension plan operated by the International Union of Operating Engineers rather than their hospital's single employer plan. Their pension benefits eroded over time because each time the hospital changed owners the pension plan was replaced. One nurse noted that she had been covered by six separate single employer DB plans, even though she remained working in the same job. She could not predict the benefits from any of them. "Delinking Benefits from a Single Employer: Alternative Multiemployer Models." Benefits for the Workplace of the Future. Olivia S. Mitchell, David S. Blitzstein, Michael Gordon, Judith F. Mazo, Editors. Philadelphia: University of Pennsylvania Press. 2003. Pp. 260–284

cost effective, and efficient ways to deliver a secure portable pension.[2] But they do much more because they solve a number of important labor market problems.

Economic Logic of Multiemployer Plans

Employers want trained workers but can't often afford the pensions, health, and training programs that produce the necessary skills especially if their competitors don't also pay for the same kinds of programs. No one employer is better off if they provide these programs alone, they are all better off if they cooperate and share in the cost. This classic public good or collective action problem is solved by multiemployer plans; all employers facing unstable product demand (and thus engage in frequent layoffs and re-hiring) benefit by having a ready supply of skilled workers and all employers pay their fair share. This (availability of skilled workers) adds to the productive capacity of an industry.[3] Such employers exist in the building and construction, retail food, trucking, health care and entertainment industries. This economic logic of multiemployer plans is under appreciated. Furthermore, these plans are part of a process by which secondary and third tier jobs are transformed into middle class jobs.

This transformative capacity bears appreciation. Construction workers in every other developed democracy occupy the bottom of the labor food chain, whereas many of America's construction workers are skilled middle class workers. Multiemployer apprenticeship, health, and pension plans are partly responsible. (The laborer without the multiemployer portable pensions has no incentive to stay connected to an occupation's skill and would very well float from construction, to retail, etc. with economic fluctuations.)

Employers benefit from the portability aspects in other ways. Take for example, UPS, a firm that provides good, but physically tough, work. A UPS worker who can't take the strain is more willing to move easily to a companion employer because they don't lose pension credits. This helps UPS maintain high performance standards.

A chief and brilliant feature of multiemployer plans are that employers' needs for predictable contributions and workers' need for predictable benefits are both represented in the joint governance structure of the trust. The PBGC does not bailout multiemployer plans and the insured levels are a maximum $13,000 compared to the $44,000 maximum in the single employer plan. As the GAO notes this structure puts much more financial risk on the multiemployer programs so the employers and participants have much more incentives to find collaborative solutions to financial difficulties.[4] (Multiemployer plans are hybrids—contains the best of both worlds—they act like defined contribution plans for employers and defined benefit plans for workers and retirees.)

If So Multis are So Good Why Don't More Employers Have Them?

If multiemployer pensions are so good why don't more employers have them and why do some want to get out. In industries characterized by large numbers of small to medium sized employers and/or a mobile workforce employers can't seem to be able to cooperate enough to create and maintain these plans without a coordinating agent, that role is played by the union and the jointly trusteed plan. (The largest pension plan is the multiple employer plan—TIAA—CREF and it was initiated by a grant from the Carnegie Foundation.) Maintenance of long term agreements requires disciplined contributions, long term commitments, and a flexible structure that can weather business cycles.

The general rules governing an employer's withdrawal from a multiemployer plan require that an employer who ceases to participate in a fund that has unfunded vested benefits, be assessed its proportionate share of those unfunded vested bene-

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[2] Approximately 60,000 employers contribute to the 1,661 multiemployer defined benefit plans and that upwards of 90% of such contributing employers are small to medium sized businesses, employing fewer than 100 employees and averaging fewer than 20. Statement Randy G. DeFrehn testimony to Subcommittee on Employer–Employee Relations, U. S. House of Representatives, "Reforming and Strengthening Defined Benefit Plans: Examining the Health of the Multiemployer Pension System. March 18, 2004

[3] Currently the Pension Rights Center's Conversation on Coverage (funded by the Ford Foundation), the GAO Retirement Advisory Panel, The DOL's ERISA Advisory Panel of 2002 and my ongoing research project entitled "Pensions and Low Income Workers: What Works?" funded by the Retirement Research Foundation in Chicago Illinois are exploring how to use the best aspects of the multiemployer system to cover more workers. The inspiration is motivated by the perceived failure of individual based efforts incented by tax breaks to get the majority of workers without pensions to save for their retirement

[4] GAO, Testimony of Barbara Bovbjeg, Subcommittee on Employer–Employee Relations, U. S. House of Representatives. "Private Pensions: Multiemployer Pensions Face Key challenges to Their Long–Term Prospects." March 18, 2004.p. 7.

fits.[5] Letting employers opt out of withdrawal liabilities would have unintended consequences since the whole system is based on long term structure.[6]

Tax deductibility of pension contributions surely incents pensions but they also invite tax avoidance. Congress imposed full funding limitations so that large employers couldn't use the pensions to shelter profits from tax. That is not an issue with multiemployer plans.[7] Since multiemployer plans bear a lot of their own financial risk and thus aim to smooth benefits and employer contributions Congress should help the funds' accumulate a contingency reserve in good times to offset the bad times when steep and prolonged declines in the investment markets and employment deplete funds. Multiemployer plans should be excluded from the maximum deductible limits.

Blue Sky Ideas

But the abundance of investment returns is not our problem now. The fad toward short term employment contracts and 401(k) type pensions—with outrageously high retail fees—shrink the number of employers wiling to be in single and multiemployer DB plans and the number of workers with pension coverage.

Given the high performance aspects of multiemployer plans here are some blue sky ideas to consider:

Encourage consortiums of employers to enter into trust agreements with a trade association or other groups of workers, in addition to encouraging the traditional route to multiemployer plans, through the collective bargaining agreement.

Encourage more non-profit-like multiple - employer DC plans (like my university faculty TIAA–CREF plan). There must be some way cooperative efforts can reduce the high costs workers face to manage their DC accounts and convert lump sums into annuities.

Investigate the consulting industries codes of conduct to find out why prudent experts aren't; incentivize defined benefit plans to change their investment strategies not to be dependent on stock equity in order to reduce the risk of underfunding volatility.

Thank you very much. I welcome any questions you may have.

Chairman JOHNSON. Thank you, ma'am. I appreciate those comments. Mr. Lynch, the PBGC uses an automated screening process that measures plans against funding and financial standards that assist PBGC in determining which plans may be at risk of termination or insolvency. Would it be appropriate to use this screening process as a standard for determining when benefit increases or accruals should be automatically frozen?

Mr. LYNCH. I certainly think the PBGC process should be upgraded and moved further up in the process. Whether or not it should be strictly limited to a clamp on benefit increases, I'm not sure that necessarily is the only answer to the problem. But, clearly, we have in—in our opinion today is you've got plans that go long, and the remedies that are available to them, either by perception or by reality, are really last-ditch remedies. When they go to the PBGC or when they go to the IRS for funding relief, waive relief, whatever it may be—

Chairman JOHNSON. It's too long?

Mr. LYNCH. They're pretty much getting near death's doorstep. And what we think needs to have happen is something earlier in the process, particularly, for plans that are facing some pretty severe trend problems.

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[5] The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) added this requirement.

[6] The impulse to escape the cooperative is a fundamental free rider problem (it is like listening to public radio but having someone else contribute); some employers that benefit from the labor supply stability may not want to pay for it

[7] More than 75% of all multiemployer defined benefit plans encountered funding limitations during the 1990s that would have resulted in the employers' inability to take tax deductions for contributions if the trustees' action had not increase benefits (DeFrehn, March 18, 2004). This was good because the participants and the funds got the advantages of the market returns, not the employers in contribution holidays.

Chairman JOHNSON. What do you recommend is the best way for employers to hold the plans accountable, because, you know, they don't have a lot of control after the plan is initiated?

Mr. LYNCH. And that's one of the key elements of this. I mean, we negotiate a contract. We do not negotiate the benefit level. In our case we negotiated a contract that was effective April 1 of '03 with what we felt were fairly significant increases in our contribution. It wasn't but 6 months later that we got a letter from one of the larger funds, indicating that there was a significant funding problem there.

At that stage there's not really a whole heck of a lot that's available to us. I'm not a lawyer, but my first reaction was who do I sue, and when I was told I have no standing to sue anybody, that came as a little bit of a surprise. I'm not suggesting that we be given unfettered rights to sue. We certainly don't want these plans tied up in endless litigation, but I do think there has to be some movement in that direction. If the employer is ultimately going to be held accountable financially, they've got to have a little bit more control over what goes on in the interim.

Chairman JOHNSON. Thank you, sir. I'm not a lawyer either. I'll now recognize a lawyer, Mr. Andrews, for questions.

Mr. ANDREWS. Thank you very much, Mr. Chairman. I'd like to thank the witnesses for their testimony this morning. Mr. Miller, I read your recommendation—heard your recommendation about lifting funding contribution limitations on contributions by multi-employer and multi-employer plans. Do you think that there are adequate provisions in the law to be sure that once those contributions are made they will only inure to the benefit of the pensioners? Is there any loophole, any leak, any possibility that once the over-funding contribution is made that it could go somewhere else, other than the pensioners?

Mr. MILLER. I believe the anti-reversion policies are clear on the matter of qualification for tax purposes. The—when terminated, they all—they go to benefits, and, certainly, to the extent—you know, I haven't looked at that in a long time, but to the extent that's a problem, that would be easy to address to make sure that that couldn't happen.

Mr. ANDREWS. I assume the answer is right. My own understanding of this law is that it's pretty air tight, and I do think that there is—I haven't heard a good argument against pre-funding. I just haven't heard a good argument against letting employers put in whatever they think works, other than a revenue—a treasury argument.

Mr. Kent—Mr. Lynch—excuse me—you would like to see more remedial measures by PBGC when people show up on some sort of watch list or early warning situation. What do you think those remedial measures ought to be? Mr. Johnson—Chairman Johnson, I think, asked you the question about whether we should—what the trigger should be to have PBGC take a look. Let's assume we've hit the trigger, and they're looking and they see someone who's going to be in trouble. What kinds of tools do you think we should give PBGC to use?

Mr. LYNCH. You made reference in your opening comment about do no harm. I'll add another one to that, and I sort of fit the medi-

cine for what ails the patient. If it is a case where a plan comes in there with a disproportionately large number of beneficiaries, who, as I indicated, no longer have a contributing employer, I think that suggests a certain remedy. And, frankly, not a particularly pleasant one with respect to what you may have to do in terms of future benefits.

Mr. ANDREWS. What is the remedy?

Mr. LYNCH. I'm sorry.

Mr. ANDREWS. What would that remedy look like?

Mr. LYNCH. It could take the form of some type of ratio that will, in fact, have to reduce the benefit based on the amount that's recovered from the now defunct employer. That is one area that we can look at.

When a plan goes to the IRS with a very severe funding problem, they are permitted at that stage to freeze benefits or accruals back 2 years. That's certainly not a happy circumstance for anyone, but applying that remedy that late in the game, may not be the best point to do that.

Mr. ANDREWS. There are no easy choices. I certainly understand that. Dr. Ghilarducci, in the blue-sky category, what do you think is the single most powerful idea for getting private pensions for people who don't have them today?

Dr. GHILARDUCCI. Probably, adding—for low-income workers probably adding something on top of Social Security, so there's USA Credit, this mandatory defined contribution supplement to Social Security actually. In this realm and without your national mandate for a Social Security supplement, I think the voluntary employee idea with maybe some tax credits for low-income workers would do it.

Mr. ANDREWS. The tax credit would operate as a match?

Dr. GHILARDUCCI. Yes.

Mr. ANDREWS. So if an employee makes a voluntary contribution, there would be a refundable tax credit as a match?

Dr. GHILARDUCCI. Right. Or people could have their EITC go into—that would be actually very easy to do to go right into their retirement savings. I think the cash balance plans are the future of the defined benefit plan.

Mr. ANDREWS. So the idea is that a person could choose to designate a portion of her or his EITC to pension contributions?

Dr. GHILARDUCCI. Right.

Mr. ANDREWS. Very interesting. We just have to expand the EITC, right? We tried to do that yesterday on the House floor. Thank you very much.

Chairman JOHNSON. That is a good idea. Thank you for it. Mr. Kline, do you care to comment?

Mr. KLINE. I do, Mr. Chairman. Thank you very much and thank the panelists for being here today. I very much appreciated the testimony of all three of you.

I'm hearing an awful lot from the truckers in Minnesota, so I'm going to sort of focus my discussion on Mr. Lynch here. I perfectly welcome anybody else to jump in, but I'm hearing from truckers in Minnesota in some cases that they are, frankly, in big trouble. That this is really having an impact. Keeping the multi-employer plan

fund is really having an impact on their bottom line and in some cases in their ability to stay in business.

And, Mr. Lynch, I'm looking at your sort of striking list of the top 50 LTL carriers in 1979 and the six that are remaining today. Clearly, there are some major issues facing the multi-employer defined benefit plans in the trucking industry.

And there was a discussion earlier in testimony about withdrawal liability, and I believe you state, Mr. Lynch, in your testimony that the withdrawal liability has been a barrier to new contributing employers from coming into the plans. Should plan trustees have the flexibility to adjust the benefit levels for the employees of an employer who withdraws from the plan?

Mr. LYNCH. I believe they should. I believe that if—for a plan that faces a disproportionate number of beneficiaries who are in that category—the option there is either a larger role for the PBGC—financial role—or it is continued to put the burden on the existing contributing employers, and that is a dwindling number to the point where they are now going to be paying for, not only their own retirees, but this ever burgeoning group of other company retirees to which they had no connection with.

And the underlying premise of a multi-employer plan is that the list of 50, if they go out, there will be somebody coming in. Unfortunately, in our industry there has been nobody of the similar size coming in to replace the ones who have gone out.

Mr. KLINE. Thank you. You state in your testimony that consideration should be given to requiring that the level of plan benefits be more closely tied to the level of plan contributions and available assets. Could you just take a minute and expand on that.

Mr. LYNCH. Again, that goes to the very difficult and tough issue of benefits. But it does, in fact, come down to simple math. If you've only got a hundred dollars coming in and you've got two hundred going out, it isn't going to take you very long before something has to give.

Now, you can certainly go back and say put another hundred dollars in, but the track record and the burden of increased contributions for the existing employer base is likely to result in further erosion of the employer base within the plan. They just simply will not be able to compete.

Mr. KLINE. Well, it's clear to me in discussions with folks back in Minnesota that we've got a rising problem and, in fact, a fairly large problem. We've had hearings before in this Committee about the trucking industry's problems in multi-employer plans, and we all would like to see the companies stay in business and stay members of the plans and continue to make their contributions and make sure that we're protecting the benefits that all these employees are expected to get.

And the problem is that we don't have enough employers in the plans. And so do you have any suggestions as to how to attract more employers to the multi-employer system?

Mr. LYNCH. I gave a presentation to an industry group where I suggested that perhaps there could be certain tax incentives to encourage employers coming into the plans. Unfortunately, nobody in the room thought that was a particularly strong enough incentive to encourage them to enter in.

It is the single hardest problem. It is one that I think is going to have to take some real creative thought, both from the folks out here, as well as the agencies and the Congress. But, unfortunately, I don't have an answer for demographic and organizing trends.

Mr. KLINE. I'd like to extend the question to anybody else on the panel. If you've got an idea, whether it's blue sky or real-world tomorrow, on how we could get more employers to step up to this. And, again, I'm thinking sort of specifically about the trucking industry, because I know that there's a pressing problem there. Anybody else would like to chime in?

Dr. GHILARDUCCI. Well, the traditional way is if the union would organize and that's sort of the stick way to do it. At the PBGC we had the same question, and that's the question we brought up. And the idea is that some consulting firms would have to see this as a good business. You know, they would have to sell it to employers.

I think economists I think academics could help too. Because if these employers were in multi-employer plans—pension plans—they would have access to the health plans and to be—training. And these employers could actually become part of the unit of high performance rather than just sort of scraping by. Wages would increase in that industry.

So I think there has to be a sell job. I think it does make—there is some logic to it, but I don't have a quick fix.

Mr. KLINE. Yeah, thank you. It does sound like there needs to be a sell job. There needs to be a buy job but with employers in trouble I think it would be pretty hard—it seems to me it's increasingly hard to get them to buy into this. So you have to find a real salesman if you're going to get them to do that. Thank you, Mr. Chairman, I yield back.

Chairman JOHNSON. Thank you. I appreciate the testimony of all three of you, and it sounds like to me, Rocky, when you were talking the doctor was shaking her head yes on a lot of what you said.

So I don't think we're too far away from finding a solution to this problem from a Congressional viewpoint anyway. And we'll start working on it, and, hopefully, come up with an answer that we can all be proud of. And I thank you so much for your attendance and for the members who are here. If there's no further business, the Committee stands adjourned.

[Whereupon, at 12:05 p.m., the Subcommittee was adjourned.]

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