PRESIDENT'S PROPOSAL FOR SINGLE-EMPLOYER PENSION FUNDING REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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PRESIDENT'S PROPOSAL FOR SINGLE-EMPLOYER PENSION FUNDING REFORM

TUESDAY, MARCH 8, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:00 p.m., in room 1100, Longworth House Office Building, Hon. Dave Camp (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 226–5911
March 08, 2005
SRM–1

Camp Announces Hearing on the President's Proposal for Single-Employer Pension Funding Reform

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the President's proposal for single-employer defined benefit pension funding reform. **The hearing will take place on Tuesday, March 8, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 3:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

On April 10, 2004, the Pension Funding Equity Act of 2004, P.L. 108–218,was signed into law. The new law temporarily replaced the obsolete 30-year Treasury interest rate, which companies are required to use for certain defined benefit pension calculations, with a new discount interest rate based on long-term corporate bonds. This new discount interest rate was enacted temporarily to give Congress and the Administration time to develop a permanent replacement in the context of comprehensive funding reforms. The temporary discount rate will expire for plan years after 2005.

In January 2005, the Administration released a comprehensive funding reform proposal for single-employer defined benefit pension plans. The proposal, which was included in the Administration's fiscal year 2006 budget submission, would: (1) permanently replace the 30-year Treasury interest rate with a yield curve rate based on corporate bond rates, (2) reform and simplify the existing funding rules that govern single-employer pension plans, (3) improve disclosures to plan participants, investors and regulators, (4) increase premiums paid to the Pension Benefit Guaranty Corporation (PBGC) to reflect inflation and increased risk of underfunded plans, and (5) impose certain restrictions on underfunded pension plans.

In announcing the hearing, Chairman Camp stated, "This hearing will provide us with an important opportunity to examine the Administration's pension funding proposals and the effect these proposals will have on workers, pension plans and the PBGC. I look forward to working with the Administration to reform the outdated funding rules and to make sure we protect workers' pension benefits."

FOCUS OF THE HEARING:

The focus of the hearing is to discuss the financial condition of the PBGC. The Subcommittee will examine the effect of the President's pension funding reform proposals on the PBGC and on defined benefit pension plans.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, February 24, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

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1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman CAMP. The hearing will come to order. I ask our guests to please take their seats. At our first hearing of the year, let me welcome to the Subcommittee on Select Revenue Measures our newest Members, John Linder, Melissa Hart, Chris Chocola, John Larson, and Mike Thompson. I am sure each will be a valuable asset to the Subcommittee. The purpose of this hearing is to examine the President's comprehensive funding reform proposal for single-employer defined benefit pension plans. The proposal was included in the President's fiscal year 2006 budget.

It is widely accepted that the Pension Benefit Guaranty Corporation (PBGC), faces serious financial challenges. It is important to understand the problems. We can strengthen the PBGC, which steps in and assumes the liabilities for defined benefit plans no longer able to meet their commitments. We will also review the Administration's permanent solution to replace the 30-year Treasury bond rate which has become obsolete in recent years. Last year, the Pension Funding Equity Act of 2004 (P.L. 108–218) included a new discount rate based on long-term corporate bonds. This measure was a temporary solution to give Congress and the Administration time to develop a permanent replacement in the context of comprehensive funding reforms. However, this provision is set to expire for the plan years after 2005. Ultimately, our goal should be to ensure that pension plans are appropriately funded, so that workers can depend on the benefits they have earned and have been promised. This important issue should be addressed this year.

Our first witness will be Mr. Bradley Belt, who is the Executive Director of the PBGC. He will give us an overview of the financial status of the PBGC. We will hear from Mark Warshawsky from the U.S. Department of the Treasury and Ann Combs from the U.S. Department of Labor, who will provide information about the Administration's pension funding reform proposal. In our second panel, we will hear from representatives of the American Academy of Actuaries, the Center for American Progress, and General Dynamics Corporation. I thank all of you for coming today. Before we hear from our first witness, I yield to my friend and colleague from New York, Mr. McNulty, for any opening comments he would like to make.

Mr. MCNULTY. Thank you, Mr. Chairman. I am going, with your permission, to submit my entire statement for the record and welcome you as our new Chair, to welcome all of the new Members of the Subcommittee. I look forward to working with you in the same bipartisan spirit with which we worked with Jim McCrery. I look forward to working with you on this and other important issues during the 109th Congress.

[The opening statement of Mr. McNulty follows:]

Opening Statement of The Honorable Michael R. McNulty, a Representative in Congress from the State of New York

Thank you, Mr. Chairman. I am pleased to serve again as the Ranking Member of the Select Revenue Measures Subcommittee. I personally want to welcome our new Subcommittee Chairman, Congressman David Camp. I look forward to a busy schedule, a good bipartisan working relationship and many legislative accomplishments.

We begin our agenda with the high profile issues surrounding pension reform. Before us are the President's legislative proposals for significant reform of the single-employer pension plan system. These proposals deserve our careful review. Defined benefit plans provide a secure source of retirement income for millions of American workers. While there has been a reduction in defined benefit plans, more than 34 million Americans participate in a defined benefit plan. For these workers and their families, it is imperative that we do everything possible to ensure that promised retirement benefits are realized.

It is critical that we proceed to create balance in our pension system between all the competing desires, rights and responsibilities. We need to maintain a willingness to be flexible and accomplish the task set before us. Employers need some flexibility to establish and maintain defined benefit plans. Workers need the assurance that their pension benefits will be there for them during their golden years. The defined benefit plan system needs to be protected and restored. And, the financial stability of the Pension Benefit Guaranty Corporation must be assured.

It is important that the Subcommittee hold this hearing because the viability of our defined benefit system is at stake. Seeking to balance the various competing interests will not be an easy task, but it must be done. Employers will continue to place great value on offering good benefits to attract and retain the best employees. Workers will continue to desire financially meaningful and secured retirement benefits. This must be accomplished with a strong Pension Benefit Guaranty Corporation to back the promised benefits. I look forward to working with the Administration, all the Members of this Subcommittee, employers, and employees to accomplish this great challenge.

As we examine these issues, we can no longer shy away from the issues surrounding cash balance plans. To ensure the long-term viability of our defined benefit system, it is necessary to provide employers with the clarity and certainty needed to move forward in this area. Hybrid plans offer employees reliable and valuable retirement benefits that become more valuable in our culture of "do-it-yourself" for American workers. Such benefits can no longer be discounted as many baby-boomers approach retirement with inadequate retirement savings.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman CAMP. Thank you very much. I look forward to working with you as well. Now for our first panel, we will begin with Mr. Bradley Belt, Executive Director of the Pension Benefit Guaranty Corporation. You have 5 minutes. Any written statement you may wish to make will be placed in the record.

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

Mr. BELT. Thank you, Mr. Chairman, Ranking Member McNulty, and Members of the Subcommittee. I commend you for holding this very timely hearing and I very much appreciate the opportunity to discuss the need for comprehensive pension reform. My written testimony does describe, in detail, the financial status of the pension insurance program and the flaws in the current funding rules that have led us to this point.

I would like to mention just a few key points that highlight the need to enact the Administration's reform proposals, which my colleagues will discuss momentarily. The first point is we have already dug a fairly deep hole and it could get much deeper if we do nothing. PBGC's accumulated deficit was just over $23 billion at the end of fiscal year 2004. That is a $30 billion swing in just 3 years. The most recent snapshot taken by the PBGC finds that corporate America's pension promises are underfunded by more than $450 billion. More important, almost $100 billion of this underfunding resides in pension plans at greater risk of termination because the sponsoring company faces financial difficulties. I would note, Mr. Chairman, that the risks of further significant losses are not limited to the steel and airline industries. Yes, the most immediate threat comes from the airline industry. The PBGC recently absorbed the underfunded pensions of U.S. Airways at a cost of $3 billion, and United Air Lines wants to saddle the insurance program with a claim of more than $6 billion. Other airline executives have publicly stated that they will feel competitive pressure to follow suit if United Airlines successfully transfers its pension costs to the insurance program.

The problem extends well beyond the airline industry. As I noted, we estimate that non-investment-grade companies sponsored pension plans with total under-funding shortfall of $96 billion. More than two-thirds of this exposure is outside the airline industry and includes manufacturing, communications services, and the wholesale and retail trade sectors. It would also be a mistake to assume that these are merely cyclical problems and a return to the bold markets of the nineties will save the day. We can't predict the future path of either equity values or interest rates. While equity markets have performed reasonably well in recent months, long-term interest rates have stayed near historic lows. More important, rising markets would not address the underlying structural flaws in the pension system.

That leads to my second point, that the status quo rules have led us to this hearing. Simply put, the current funding rules fail to ensure that pension plans are adequately funded. Rather than encouraging prudent funding levels and dampening volatility, the use of smoothing mechanisms and credit balances have allowed companies to avoid making contributions to the pension plans and become substantially under-funded. The sad fact is that companies can comply with all of the requirements of ERISA and the Internal Revenue Code and still end up with plans that are much less than 50 percent funded when terminated. The system is rife with what economists call moral hazard. A properly defined insurance system has mechanisms for encouraging responsible behavior and discouraging risky behavior. Unfortunately, the incentives in the pension insurance program run the other way. A weak company has incentives to make generous pension promises rather than increase wages, and employees may go along because the benefits are guaranteed. If the company recovers, it may be able to afford the increased benefits. If not, the costs are shifted to other companies through the insurance fund. In addition, the system suffers from a disturbing lack of transparency. The current disclosure rules obfuscate economic reality, shielding relevant information about the funded status of pension plans from participants, investors, and even regulators.

The third and most important point, Mr. Chairman, is that this is not about the solvency of the PBGC. It is about the retirement security of millions of Americans. The Administration is committed to defined benefit plans, which are an important source of secure retirement income. When plans terminate, workers' and retirees' expectations of a secure future may be shattered, because, by law, not all benefits promised under a plan are guaranteed. In addition, every company that sponsors defined benefit plans also pays a price through higher premiums when underfunded plans terminate. Not only will healthy companies be subsidizing weak companies with chronically underfunded pension plans, they may face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government. In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would cause responsible premium payers to exit the system. If this were to occur, Congress would face pressure to have U.S. taxpayers pay the benefits of workers whose pension plans failed.

Mr. Chairman, the issues surrounding defined benefit pension plans ultimately boil down to one question: who will pay for the pension promises that companies make to their workers? There are only four choices: the company that made the pension promise; other companies through higher PBGC premiums; participants through lower benefits; or taxpayers through a rescue of the insurance fund. The Administration believes that companies that make pension promises should pay for their pension promises and not shift the cost to the others. Thank you for inviting me to testify. I would be pleased to answer questions.

[The prepared statement of Mr. Belt follows:]

Statement of Bradley Belt, Executive Director, Pension Benefit Guaranty Corporation

Mr. Chairman, Ranking Member McNulty, and Members of the Subcommittee: Good afternoon. I want to commend you for your leadership on retirement security issues, and I appreciate the opportunity to discuss the challenges facing the defined benefit pension system and the pension insurance program, and the Administration's proposals for meeting these challenges.

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

Introduction

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

That system, however, has on occasion been beset by problems that have undermined the economic security that workers and retirees have counted on. For example, the bankruptcy of the Studebaker car company in the early 1960s left thousands of workers without promised pension benefits. In such cases Congress has been called upon to safeguard the benefits workers were expecting—indeed, Studebaker was the catalyzing event that led to the passage of the Employee Retirement Income Security Act (ERISA) and the creation of the Pension Benefit Guaranty Corporation a decade later.

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

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

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

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers.[1] If

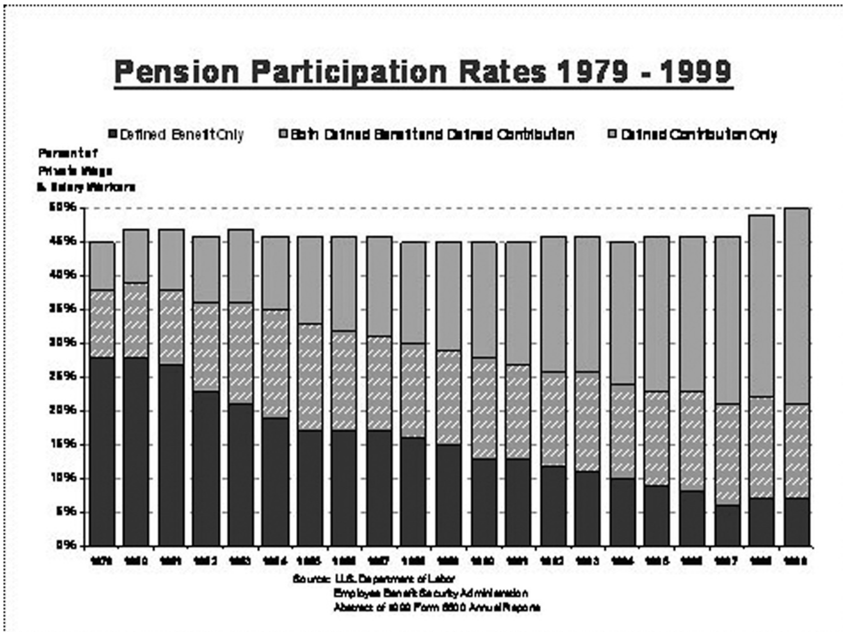
[1] See page 3, *Pension Tension*, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of time. As I will discuss in more detail, the status quo statutory and regulatory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

State of the Defined Benefit System

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

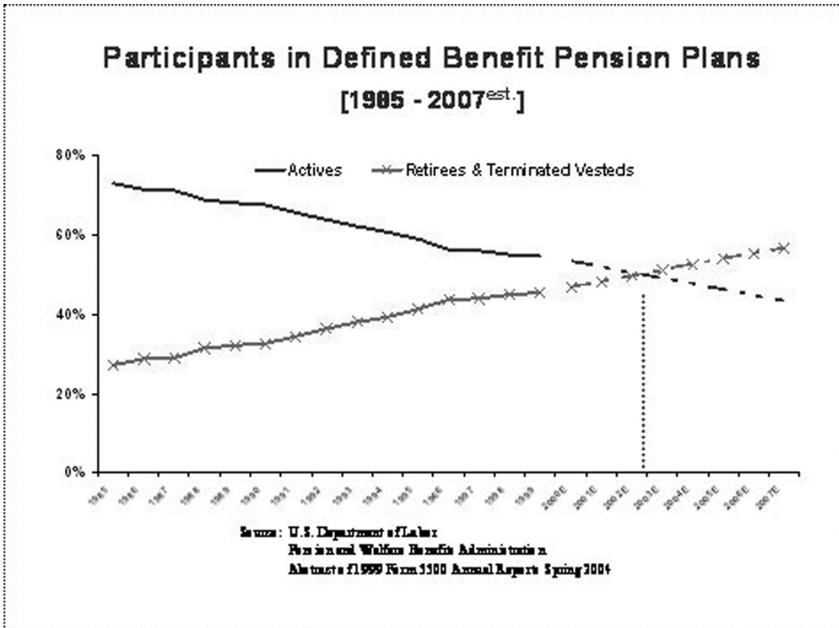


In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had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

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

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

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



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

For example, in lieu of outright termination, companies are increasingly "freezing" plans. Surveys by pension consulting firms show that a significant number of their clients have or are considering instituting some form of plan freeze.[2] Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program.

Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants.[3] Unfortunately, as a result of a single federal court decision, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees[4]

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[2] See, e.g., Aon Consulting, *More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So*, Oct. 2003; Hewitt Associates, *Survey Findings: Current Retirement Plan Challenges: Employer Perspectives* (Dec. 2003).

[3] Table S–35, PBGC Pension Insurance Data Book 2004 (to be issued April 2005).

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

The Role of the PBGC

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

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

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

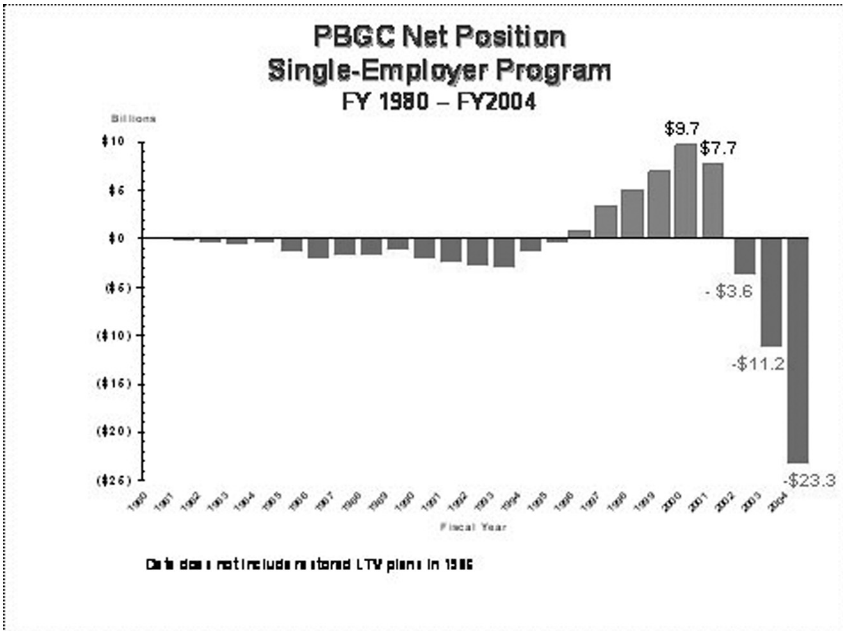
Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension plans trusteed by PBGC, investment income, and recoveries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

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

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

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

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

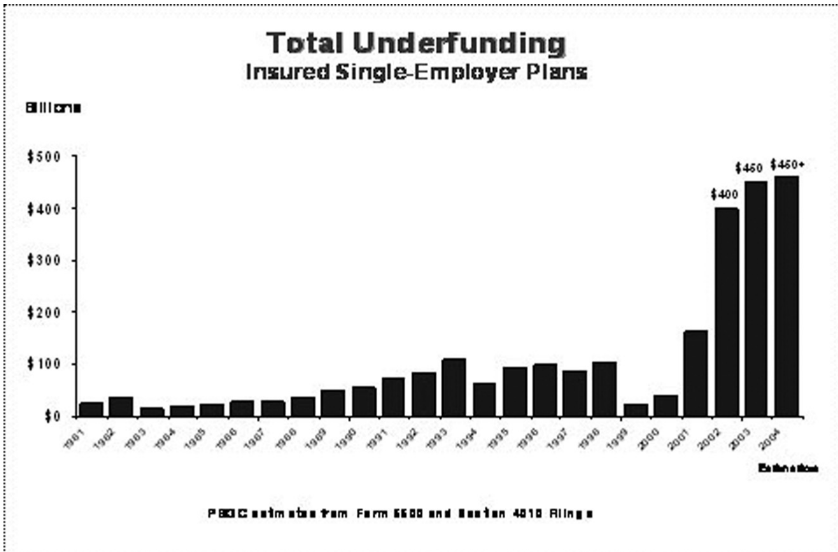


Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with $62 billion in liabilities and only $39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the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

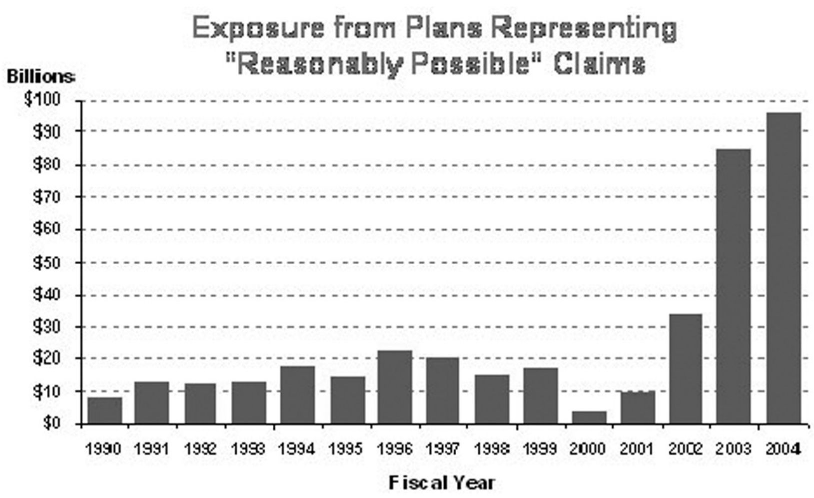
Mounting Pressures on the Pension Safety Net

In addition to the $23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than $50 billion. Two years later, as a result of a combination of factors, including declining interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total underfunding exceeded $400 billion.[6] As of September 30, 2004, we estimate that total underfunding exceeds $450 billion, the largest number ever recorded.

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



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



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

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

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

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

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

Reasonably Possible Exposure

(Dollars in Billions)

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

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

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

increase dramatically.[8] The consensus forecast predicted that long-term interest rates would have risen sharply by now, yet they remain near 40-year lows.[9] And, a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an all-time high, with more than 90 percent of the exposure unhedged.[10]

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

Structural Flaws in the Devined Benefit Pension System

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

Weaknesses in Funding Rules

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

- The funding rules *set funding targets too low*. Employers are not subject to the deficit reduction contribution rules when a plan is funded at 90 percent of "current liability," a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. In addition, in some cases employers can stop making contributions entirely because of the "full funding limitation." As a result, some companies say they are fully funded when in fact they are substantially underfunded.[11] Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. US Airways' pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. No wonder US Airways pilots were shocked to learn just how much of their promised benefits would be lost.

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

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

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

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

Bethlehem Steel

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	78%	91%	95%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a Variable Rate Premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.5 million	$8.1 million	$0	$0	$0
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn

US Airways Pilots

Termination Benefit Liability Funded Ratio 33%

Unfunded Benefit Liabilities $2.5 billion

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

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

- The funding rules *rely on the actuarial value of plan assets to smooth plan contribution requirements.* However, the actuarial value may differ significantly from the fair market value. Actuarial value is determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of a plan.[12] Masking current market conditions is neither a good nor a necessary way to avoid volatility in funding contributions. Using fair market value of assets would provide a more accurate view of a plan's funded status. I would also note that the smoothing mechanisms in ERISA and financial accounting standards are anomalies—airlines are not allowed to smooth fuel costs; auto companies are not allowed to smooth steel prices; global financial firms are not allowed to smooth currency fluctuations.
- The funding rules *do not reflect the risk of loss to participants and premium payers.* The same funding rules apply regardless of a company's financial health, but a PBGC analysis found that nearly 90 percent of the companies representing large claims against the insurance system had junk-bond credit ratings for 10 years prior to termination.
- The funding rules *set maximum deductible contributions too low. KAs a result, it can be difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times. (However, this was not a significant issue in the 1990s—a PBGC analysis found that 70 percent of plan sponsors contributed less than the maximum deductible amount.)*

Moral Hazard

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

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

Or, labor may choose to bargain for wages or other benefits rather than for full funding of a plan because of the federal backstop.[13] If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund. Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders and much of the downside risk being shifted to other premium payers.

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

Consider: Bethlehem Steel presented a claim of $3.7 billion after having paid roughly $60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substan-

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

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

tially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a loss to the fund of more than $6 billion.

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

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

Transparency

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality. That is certainly their effect—to shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two and a half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

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

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

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

Conclusion

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

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

Chairman CAMP. Thank you very much Mr. Belt. Now we will hear from the Honorable Mark Warshawsky, Assistant Secretary for Economic Policy, U.S. Department of the Treasury.

STATEMENT OF THE HONORABLE MARK J. WARSHAWSKY, ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. WARSHAWSKY. Thank you, Mr. Chairman. Good afternoon Chairman Camp, Ranking Member McNulty, and Members of the Subcommittee. I appreciate the opportunity to participate in this hearing to discuss the Administration's proposal to reform and strengthen the single-employer defined pension benefit system. The primary goal of any pension reform effort should be to ensure that retirees and workers receive the benefits they have earned. Clearly, the current funding roles have failed to meet this goal. As part of its reform proposal, the Administration has designed a new set of funding rules that, we think, will ensure that participants receive the pension benefits they have earned from their plans. Today, I will briefly discuss a few critical issues pertaining to these funding rules, while my colleague Ann Combs will discuss the other elements of the proposal. For any set of funding rules to function well, the assets and liabilities must be measured accurately. The system of smoothing embodied in current law serves only to mask the true financial condition of pension plans and to shift the risk of unfunded liabilities from firms that sponsor underfunded plans to planned participants and other sponsors in the insurance system.

Under our proposal, by contrast, assets will be marked to go market. Liabilities will be measured using a current spot yield curve that takes account of the timing of future benefit payments, some to cross all plan participants. Discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability. Liabilities computed using the yield curve match the timing of obligations with discount rates of appropriate maturities. Proper matching of discount rates and obligations is the most accurate way to measure today's cost of meeting pension obligations. Use of the yield curve is a prudent and common practice. Yield curves are regularly used in valuing other financial instruments and obligations including mortgages, certificates of deposit, and others. The Administration recognizes that the current funding rules have contributed to funding volatility. Particular problem areas are the deficit reduction contribution mechanism and the limits on tax deductibility of contributions. Our proposal is designed to remedy these issues by giving plans the tools needed to smooth contributions over the business cycle. These tools

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

include increasing the deductible contribution limit that will give plan sponsors additional ability to fund up during good times; increasing the amortization period for funding deficits to 7 years compared to a period as short as 4 years under current law; and the freedom plans already have to choose prudent pension fund investments. Plan sponsors may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions. These, we believe, are appropriate methods for dealing with risk. We believe it is inappropriate to limit contribution volatility by transferring risk to plan participants in the PBGC.

Under our proposal, plan funding targets with healthy plan sponsors will be established at a level that reflects the full value of benefits earned to date, under the assumption that plan participant remains largely consistent with the past history of an ongoing concern. By contrast, plans sponsored by firms with below investment-grade credit will be required to fund to a higher standard that reflects the increased risk that these plans will terminate. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of default. It is only natural that pension plans with sponsors that fall into this readily observable high-risk category should have more stringent funding standards. Credit ratings are used throughout the economy and in many other government regulations to measure the risk that a firm will default on its financial obligations. A prudent system of pension regulation insurance would be lacking if it did not use this information. Credit balances are created when a plan makes a contribution that is greater than the required minimum. Under current law, a credit balance plus an assumed rate of return can be used to offset future contributions.

We see two problems with this system. First, the assets that underlie credit balances may lose rather than gain value. Second, and more important, credit balances allow plans that are seriously underfunded to take funding holidays. In our view, every underfunded plan should make minimal annual contributions. Under our proposals, contributions in excess of a minimum still reduce future minimum contributions. The value of these contributions is added to the plan's assets, and, all other things being equal, reduces the amount of time that the sponsor must make minimum contributions to the plan. While proposals that value credit balances at market value are a step in the right direction, such measures alone, without restricting funding holidays by underfunded plans, will not be sufficient. It has been my pleasure to discuss the proposal here today and my colleagues look forward to answering any questions you may have.

[The prepared statement of Mr. Warshawsky follows:]

Statement of The Honorable Mark Warshawsky, Assistant Secretary for Economic Policy, U.S. Department of the Treasury

Good afternoon Chairman Camp, Ranking Member McNulty, and members of the Subcommittee. I appreciate the opportunity to participate in this hearing todiscuss the Administration's proposal to reform and strengthen the single employer defined benefit pension system. In my testimony, I will focus on the proposal's funding rules, in particular, the calculation of the funding targets.

The single employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action, ultimately the insurance system will simply not have adequate resources to pay all the benefits that it owes to the one million workers and retirees currently owed benefits who were participants of failed plans and to the beneficiaries of plans that fail in the future.

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

A defined benefit pension plan is a trusteed arrangement under which an employer makes a financial commitment to provide a reliable stream of pension payments to employees in exchange for their service to the firm. One cannot expect that such obligations will be honored consistently if they are allowed to remain chronically underfunded as they are under current law. The incentives for financially sound plan funding must be improved or we will continue to see pension plans terminating with massive amounts of unfunded benefits. These unfunded benefits are costly both to participants because many lose benefits and also to other pension sponsors because, they are likely bear the higher costs that such underfunding imposes on the insurance system through even higher premiums.

The goal of the Administration's proposed defined benefit pension reform is to enhance retirement security. The reforms are designed to ensure that plans have sufficient funds to meet accurately and meaningfully measured accrued obligations to participants. The current defined benefit pension funding rules—which focus on micromanaging annual cash flows to the pension fund—are in need of a complete overhaul. The current rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The current rules:

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

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

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

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and as a result will moderate future insurance costs that will be borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding. We have proposed a fundamental reform of the treatment of defined benefit pension plans, one that we believe will change plan sponsor behavior, ultimately result in better funded and better managed defined benefit pension plans, and secure benefits for workers and retirees.

The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target—a measure of the currently accrued pension obligations.

Plans that fall below the minimum funding target would be required to fund-up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

Some key features of the proposed funding rules:

- *Funding based on meaningful and accurate measures of liabilities and assets.* The proposal provides funding targets that are based on meaningful, timely, and accurate (using the yield curve for discounting is a central component of this proposal) measures of liabilities that reflect the financial health of the employer.
- *Accrued benefits funded.* Sponsors that fall below minimum funding levels will be required to fund up within a reasonable period of time. The proposal requires a 7-year amortization period for annual increases in funding shortfalls. There will be restrictions on the extension of new benefit promises by employers whose plans' funded status falls below acceptable levels. Benefit restrictions will limit liability growth as a plan becomes progressively underfunded relative to its funding target.
- *Plan sponsors able to fund plans during good times.* Many believe that the inability of plan sponsors to build sufficiently large funding surpluses during good financial times under current rules has contributed to the current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. And every plan will be allowed to fund to a level of funding corresponding to the total cost of closing out the plan. Under our proposal, allowing plan sponsors the opportunity to prefund and therefore limit contribution volatility is a critical element.

Some argue that the best way to enhance retirement security is to create the appearance of well funded pension plans through the use of asset and liability smoothing and increased amortization periods for actuarial losses. In addition, plan sponsors have frequently voiced their dislike of volatile and unpredictable minimum contributions.

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

Moreover, the Administration recognizes that the current minimum funding rules—particularly the deficit reduction contribution mechanism and the limits on tax deductibility of contributions—have contributed to funding volatility. Our proposal is designed to remedy these issues; for example, we increase the deductible contribution limit. We feel this additional ability to fund during good times, combined with other provisions of the proposal; for example, increasing the amortization period to seven years compared to a period as short as four years under the current law deficit reduction contribution mechanism, together with the existing freedom of plans have to choose pension fund investments, will give plans the tools they need in order to smooth contributions over the business cycle. Plans may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions. These are appropriate methods for dealing with risk; it is inappropriate to limit contribution volatility by transferring risk to participants and the PBGC.

Meaningful and Accurate Measures of Assets and Liabilities

We propose measuring liabilities on an accrual basis using a single standard liability measurement concept that does not distort the measures by smoothing values over time. Within the single method, liability is measured using assumptions that are appropriate for a financially healthy plan sponsor (investment grade credit rated), and alternatively using assumptions that are appropriate for a less healthy plan sponsor (below investment grade) that is more likely to find itself in a position of default on pension obligations in the short to medium term.

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

The at-risk liability measure estimates the liabilities that would accrue as a plan heads towards termination because of deteriorating financial health of the plan sponsor. At-risk liability would include accrued benefits for an ongoing plan, plus increases in costs that occur when a plan terminates. These costs include acceleration in early retirement, increase in lump sum elections when available and the administrative costs associated with terminating the plan.

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

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

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

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

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

Our budget proposal to reform the calculation of lump-sum benefits also uses the yield curve for calculating the minimum lump sums. We propose to replace the use of a 30-year Treasury rates for purposes of determining lump sum settlements under qualified plans. Using the yield curve to compute lumps sums and the funding required for an annuity eliminates any distortions that would bias the participant's payout decision. Under our proposal, lump sum settlements would be calculated using the same interest rates that are used in discounting pension liabilities: interest rates that are drawn from a zero-coupon corporate bond yield curve based on the interest rates for high quality corporate bonds. This reform includes a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law. The new basis would not apply to distributions in 2005 and 2006 and would be phased in for distributions in 2007 and 2008, with full implementation beginning only in 2009.[1]

Today, I'll provide an example (economists call this a stylized example) of how the yield curve would be used in discounting pension obligations. The yield curve is used to discount the plans aggregate expected pension payments in each year to participants. The plan administrator has calculated these future pension payments based on the plan's formula for benefits that participants have earned up to the valuation date. As this example shows, once the actuary has determined the plan's annual cash benefit payments summed over all participants in a manner similar to what is done under current law, discounting those payments using the yield curve is quite simple.

Our hypothetical plan consists of three individuals, the 64-year-old Mr. Brown, the 59-year-old Ms. Scarlet, and the 54-year-old Mr. Green. Each of the three retires at age 65 and receives the same pension benefit payment each year until death at age 80. The benefit Mr. Brown has earned to date is higher than Ms. Scarlet's (it is assumed that he has been working longer under the plan) whose expected benefit is in turn larger than Mr. Green's. Mr. Brown's annual benefit under the plan is $12,000, Ms. Scarlet's is $9,000 and Mr. Green's is $6,000.

Chart 1 shows the AA corporate bond yield curve that would be used to discount these benefit payments. The yield curve has interest rates for years 0 to 80. For our stylized example we will only need to use points for the years 1 through 26 because we assume that no participant will draw benefits before year 1 and all payments will be made by year 26. The example applies the yield curve to payments made each year.

Chart 1

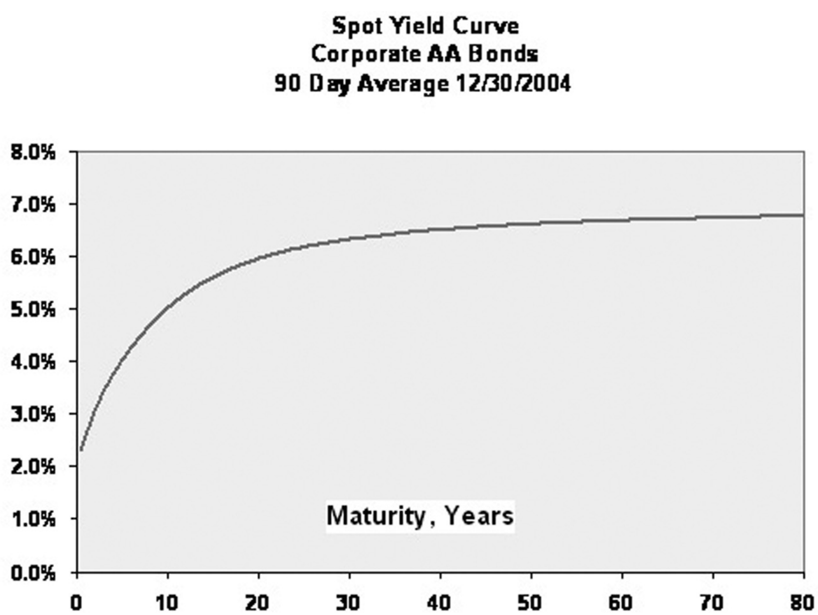


Chart 2 shows the benefit payments that each participant is expected to receive in the future. Chart 3 shows expected total payments that will be made by the plan each year in the future; this is simply the sum of payments to the three individual participants. The total benefit line takes an upward step each time a participant retires and a downward step each time a participant's benefit ends.

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

Chart 2

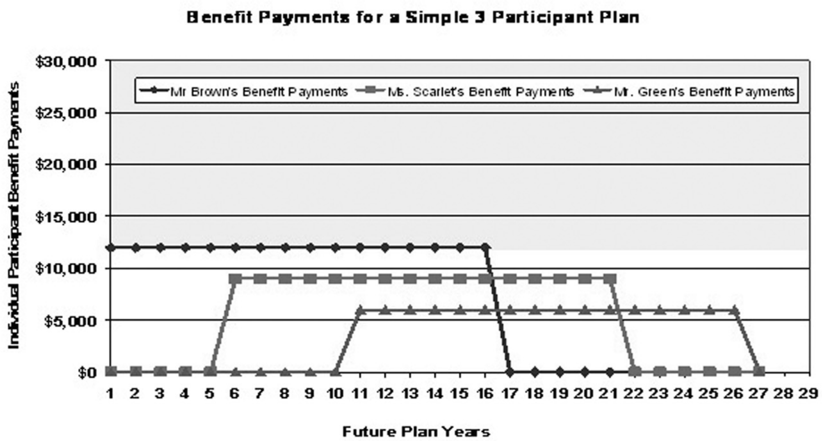
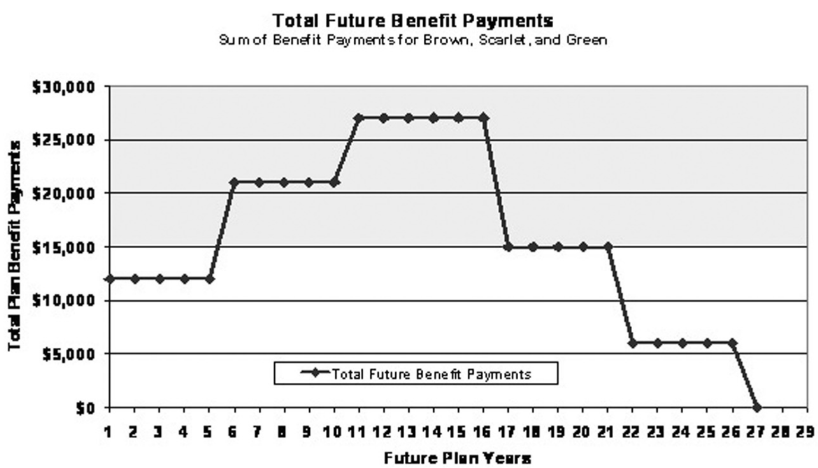


Chart 3



How do we apply the yield curve to discounting these benefit payments?

Let's take years 5, 14 and 20. In year 5, the plan expects to pay $12,000 in benefits, all to Mr. Brown. The discount rate for that year drawn from the yield curve is 4.03 percent. To compute the present value of the $12,000, the $12,000 is divided by 1.218 (one plus the interest rate expressed in decimal form, 1.0403, raised to the 5th power), which equals $9,849.

For plan year 14 the expected benefit payments are $27,000 ($12,000 to Mr. Brown, $9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the yield curve interest rate is 5.51 percent. To compute the present value, the $27,000 is divided by 2.119 (1.0546 taken to the 14th power) yielding $12,742. For year 20, the plan expects to pay $15,000 ($9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the discount rate from the yield curve is 5.96 percent. Dividing $15,000 by 3.183 gives a present value of $4,713. Note that even though there are three participants in the plan, once their benefit payments during any period are added together only one interest rate is needed to compute the present value for that period. Separate interest rates are not used for every individual participant in the plan.

In order to compute the plan's target liability the plan needs to perform computations like the one above for each payment period from 1 through 27 and sum them together. The liability for this hypothetical plan is $238,994. In this example, only 26 interest rates are used, one for each year that benefit payments are made. Even if our hypothetical plan had thousands of participants, but payments were made for only 26 years in the future, only 26 interest rates would be needed to compute the plan's liability.

This is, of course, a simplified example. The plan actuary needs to make a number of computations and use his or her professional judgment to determine the plan's future benefit payments each year: the actuary must estimate the probability that a participant will retire at a particular time in the future and must model the probable pattern of payments that will be made for that participant until the participant's death. These computations, already required by current law, are complex, but once the actuary has determined the annual cash benefit payments, discounting those payments using the yield curve is quite simple and can easily be done using a basic spreadsheet program.

As noted above, if Mr. Brown elected to take a lump sum payment rather than an annuity, the minimum value of that lump sum would also be computed using the yield curve. We have assumed that Mr. Brown will begin receiving his annual benefit of $12,000 next year and will receive the same benefit for 16 years. In order to compute the value of those future payments as a lump sum we would simply discount each period's cash flows using interest rates drawn from the yield curve to find the present value of the benefit in each future period. Then we sum those present values together to yield the minimum lump sum value. In year one, for example, the interest rate drawn from the yield curve is 2.59 percent. If the first $12,000 payment is made one year in the future its present value would be $11,697. The present value of the payment made in year 5 would be computed using the year 5 point on the yield curve that is 4.03 percent. Its present value would be $9,849. In year 12, the interest rate used to compute the present value is 5.29 percent and therefore the present value of the benefit payment is $6,465. In total, Mr. Brown's hypothetical lump sum would be valued at $131,035.

Distinction by Credit Rating

Under the Administration's proposal, the appropriately measured accrued liabilities serve as the plan funding targets. The target funding level for minimum required contributions will vary depending on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below investment grade rated) will use 100 percent of at-risk liability as their funding target.[2]

The goal of pension funding rules is to minimize benefit losses to plan participants. When pension plans default on their obligations, the PBGC is required to make benefit payments to plan participants subject to the guarantee limits. Ultimately, if plan defaults are too numerous, the insurance system will collapse and taxpayers may be called upon to fund the pension promises. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of such defaults. Therefore, it is only natural that pension plans with sponsors that fall into this readily observable high risk category should have more stringent funding standards. The at-risk liability measure is an appropriate funding target for below investment grade companies because the target reflects the plan liabilities that would accrue as a plan heads towards termination.

The table below shows the average cumulative default rate of corporate bond issuers as computed by Moody's Investor's Service (January 2005). This table indicates that, over time, below investment grade firms have a substantially higher likelihood of default than investment grade firms. The table indicates that 14.81 percent of Ba rated firms (just below investment grade) experience a default within 7 years, whereas only 3.12 percent of Baa rated firms (just above investment grade) experience a default within the same period.

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

Average Cumulative Default Rate by Credit Rating, 1970–2004 Selected Data

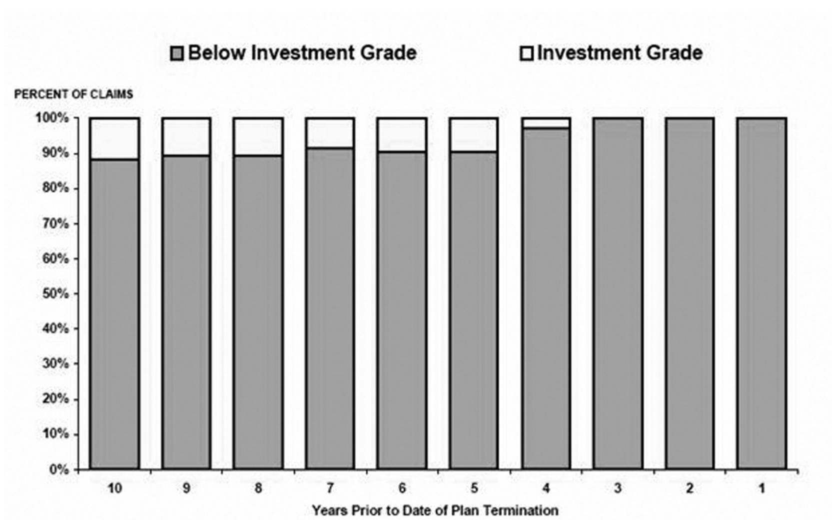
Years	Moody's Credit Rating						
	Aaa	Aa	A	Baa	Ba	B	Caa-C
1	0.00	0.00	0.02	0.19	1.22	5.81	22.43
3	0.00	0.03	0.22	0.98	5.79	19.51	46.71
5	0.12	0.20	0.50	2.08	10.72	30.48	59.72
7	0.30	0.37	0.85	3.12	14.81	39.45	68.06
10	0.63	0.61	1.48	4.89	20.11	48.64	76.77
15	1.22	1.38	2.74	8.73	29.67	57.72	78.53
20	1.54	2.44	4.87	12.05	37.07	59.11	78.53

Source: Moodys Investor Services, Global Credit Research, Default and Recovery Rates of Corporate Bond Issuers, 1920–2004, January 2005.

The following chart shows that firms generally have a below investment grade credit rating for several years prior to their plan default on pension obligations triggering a claim on the PBGC. This shows 27 largest claims to PBGC for which the series of S&P ratings were available. This suggests that while defaults are certainly not easily predictable (many other plans with below investment grade credit ratings did not default), these are clear warning signs that any responsible regulatory system should take into account. Differentiating funding targets based on credit ratings is appropriate and the investment grade/below investment grade distinction is the most useable and accurate breakpoint.

Chart 4

Debt Ratings for 27 Large PBGC Claims



Source: PBGC

Accrued Benefits Funded

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

7 annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of future amortization payments is less than the funding target, that shortfall is amortized over the following 7 years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.[3]

It is critical to note that while our proposal does away with "credit balances" as currently construed, it does not reduce the incentives to contribute above the minimum. It does, however, prevent underfunded plans from using credit balances for funding holidays. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have resulted in plans having lengthy funding holidays, while at the same time becoming increasingly underfunded. Just marking credit balances to market is not sufficient to solve the problem if underfunded plan are still able to take funding holidays. In the Administration proposal, the focus of the reformed funding rules on stocks of assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Under a reformed set of funding rules, pre-funding adds to a plan's stock of assets, thereby reducing any current shortfalls or the likelihood of potential future shortfalls relative to appropriately and accurately measured liabilities.

An Example of Funding Rules

Using another example we can demonstrate how minimum contributions would be determined under the funding proposal. Liabilities for the plan are computed over a five-year period using the cash flows and the yield curve depicted in the graphs above. (For simplicity, it is assumed that the yield curve interest rates remain constant over the five-year period.) We then begin with an arbitrarily chosen level of plan underfunding to demonstrate how the amortizations of plan deficits would work. For this example, we simplify and assume that the interest rate charged for amortization of shortfalls is zero. That means that a shortfall increase payment amortized over 7 years is merely the increase divided by 7. The normal cost is also assumed to be zero to simplify the exposition.

In year one, the plan is underfunded by $18,994. That means that the plan must contribute a minimum of $2,713, which is the amortization payment for $18,994 over a seven year term—in year one and for the next six years—unless the plan becomes fully funded before year seven.

In year two, the plan's funding deficit is $8,000 as a result of increases in both the value of assets and liabilities. Since this new shortfall is less than the value of future contributions (we assume that the plan will make future contributions so their present value effectively becomes an asset) the increase in the shortfall is zero. Under the amortization rules no *new* payment is required; because the plan is still underfunded, however, a second payment of $2,713 must be made. The amortization rule is designed to encourage plans to fund up quickly in order to protect participants' pensions. For that reason, the amortization payment of $2,713 is not reduced even though the plan's funded status has improved.

In year 3, the funding shortfall increases to $18,367 because the value of assets has fallen. Because this is $4,800 more than the value of the remaining amortization payments, a new payment of $686 is added to the existing payment of $2,713 meaning that total contributions are $3,399 in year 3.

In year 4, because of an increase in asset values, the plans deficit falls to $9,283. This is less than $14,968, the value of the remaining shortfall payments from year 1 and year 3 so there is no new payment and the required contribution remains $3,399.

In year 5, asset values rise again and the plan is now fully funded. Because the plan no longer has a funding deficit, no minimum contribution is required and all past amortization payments are cancelled.

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

Table 2
Minimum Funding Example

Year		**1**	**2**	**3**	**4**	**5**
Assets		**$220,000**	**$242,000**	**$225,060**	**$236,313**	**$250,492**
Liabilities		**$238,994**	**$250,000**	**$243,427**	**$245,596**	**$247,656**
Shortfall		**$18,994**	**$8,000**	**$18,367**	**$9,283**	**$0**
Value of Remaining Year 1 Pmts.			$16,281	$13,567	$10,854	$8,140
Value of Remaining Year 2 Pmts.				$0	$0	$0
Value of Remaining Year 3 Pmts.					4,114	3,429
Value of Remaining Year 4 Pmts.						$0
Value of All Remaining Payments		$0	$16,281	$13,567	$14,968	$11,569
Shortfall Increase		**$18,994**	**$0**	**$4,800**	**$0**	**$0**
Minimum Contribution for: Year 1 Shortfall Increase		$2,713	$2,713	$2,713	$2,713	$0
Year 2 Shortfall Increase			$0	$0	$0	$0
Year 3 Shortfall Increase				$686	$686	$0
Year 4 Shortfall Increase					$0	$0
Year 5 Shortfall Increase						$0
Total Minimum Contribution		**$2,713**	**$2,713**	**$3,399**	**$3,399**	**$0**

Benefit Restrictions

Finally, we have proposed benefit restrictions that will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of liabilities when plans are becoming dangerously underfunded in order to ensure that plan participant will collect benefits that they accrue. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in many situations even make benefit improvements. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likely losses faced by participants and large claims to the PBGC. To guard against this type of moral hazard, if a company's plan is poorly funded, the growth in the plan's liabilities should be limited unless and until the company funds them, especially if the company is in a weak financial position.

Plan sponsors able to fund plans during good times

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The importance of these mechanisms that I have described is not simply to force plans to fund-up quickly and reduce the rate at which new obligations accrue. Their importance is also that rational, forward looking managers will respond to these reforms by taking steps to ensure that plans remain well funded on an ongoing basis. The Administration plan matches new responsibilities, to more fully fund pension obligations, with new opportunities—an enhanced ability to pre-fund obligations on a tax preferred basis.

Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed significantly to current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. Every plan will be allowed to fund to at least at-risk Liability.

The first cushion is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability values fluctuations that occur over a business cycle. Plan sponsors would also be able to build a second funding cushion that allows them to pre-fund for salary or benefit increases.

Conclusion

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

It has been my pleasure to provide this detailed discussion of some of the critical elements of the proposal. My colleagues and I are available and look forward to discussing the proposal and the motivations for the proposal and answering any additional questions you may have.

Chairman CAMP. Thank you very much. Now the Honorable Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor.

STATEMENT OF THE HONORABLE ANN L. COMBS, ASSISTANT SECRETARY, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Ms. COMBS. Thank you, Mr. Chairman. Good afternoon, Chairman Camp, Ranking Member McNulty, and Members of the Subcommittee. Thank you for inviting us here today to discuss the President's proposal to reform the defined benefit pension system. The defined benefits system needs comprehensive reform. Mere tinkering with the current rules will not fix its problems. The Administration's reform package will improve pension security for workers and retirees, stabilize the defined benefit system, and avoid the need for a taxpayer bailout of the PBGC. I will focus today on three elements of the proposal: preventing hollow benefit promises by severely underfunded plans; improving disclosure to workers, investors and regulators; and reforming PBGC's premiums to better reflect the real risks and the costs of the pension guaranty system.

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

First, the proposal would allow a plan to increase benefits only if the plan is more than 80 percent funded, or if the new benefits are fully and immediately funded. Second, a plan could not make lump sum payments unless it is more than 60 percent funded, or if the plan sponsor is financially weak, more than 80 percent funded. This will ensure that workers are treated fairly, preventing a run on the bank where a few collect at the expense of those left behind in the plan. Third, plans sponsored by financially weak companies that are less than 60 percent funded would have no new benefit accruals until their funded status improves. A plan sponsored by a bankrupt company would be frozen until the plan is fully funded.

Our proposal also prevents corporate executives from securing their own retirements while workers' plans are at risk, an abuse recently seen in the airline industry. Financially weak companies, with severely underfunded plans, could not secure nonqualified deferred executive compensation arrangements. Funds used for this purpose could be recovered by the underfunded pension plan. Plans that become subject to any of these benefit limitations would be required to notify affected workers, making them aware that deteriorating funding is threatening their benefits. The restrictions create a strong incentive for employers to adequately fund their plans, and they ensure that the promises already made to workers are honored before additional empty promises are made, raising false expectations that cannot be met.

The financial health of defined benefits plan must be transparent and fully disclosed to workers and retirees, as well as to regulators and investors. The Administration's proposal would accelerate and improve annual disclosures to covered workers and retirees. Each plan would disclose its funded status relative to its funding target for the current year and the two preceding years along with the company's financial health and the PBGC guarantees. These disclosures will ensure that workers have the information they need to talk to their employers about funding their plans and to make informed choices about their retirements. It will correct the current situation, where so many workers and retirees have lost benefits with little or no advanced warning, having been told that their plans were adequately funded.

Another key reform is to improve the timeliness and accuracy of annual plan reports to the government. Under current law, the information reported doesn't accurately measure assets and liabilities and can be nearly 2 years out of date. We would require plans to report annually the market value of their assets and the ongoing and at-risk value of their liabilities, as well as shorten the deadline for large underfunded plans to report their actuarial information. In addition, our proposal allows information filed by certain underfunded plans with the PBGC to be disclosed to the public, except for certain sensitive information, such as trade secrets.

Finally, our proposal will help restore the financial integrity of the Federal insurance system by improving the PBGC premium structure. It would immediately adjust the flat rate per-participant annual premium to $30 to reflect the growth in worker wages since 1991, when the current $19 figure was set. Going forward, the rate would be indexed to wage growth similar to the PBGC guaranty limit. All companies with underfunded plans would pay an additional risk-based premium based on the plan's funding shortfall. The rate would be set periodically by the PBGC board to ensure sufficient premium revenue to meet expected claims and pay off the current deficit over time. The new risk-based premium based on accurate funding targets that reflect the sponsor's financial condition will be far more reflective of actual risk than the current law variable rate premium. To keep premiums to a reasonable level by reducing unreasonable risk, we would freeze the PBGC guaranty limit when a company enters bankruptcy, allow the PBGC to perfect liens for missed required contributions, and prospectively eliminate the guaranty of shutdown benefits, and prohibit such unfunded benefits in pension plans.

In conclusion, the Bush Administration is committed to working with you and Congress to ensure that meaningful defined benefit pension reforms are enacted into law. We look forward to working with the Members of this Subcommittee to achieve greater retirement security for the millions of Americans, workers, retirees and their families who depend on defined benefit plans. Thank you very much.

[The prepared statement of Ms. Combs follows:]

Statement of The Honorable Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor

Introductory Remarks

Good afternoon Chairman Camp, Ranking Member McNulty, and members of the Subcommittee. Thank you for inviting me to discuss the Administration's proposal to reform and strengthen the single-employer defined benefit pension system.

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

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

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

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

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

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

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

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

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

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

Reforming the Funding Rules

The funding rules are complicated and ineffective.

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

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

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

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

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

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

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

The Bush Administration's Proposal

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

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

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

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

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

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

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

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

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

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

Funding shortfalls should be made up over a reasonable period.

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

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

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

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

Opportunity to increase funding in good years.

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

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

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

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

Limitations on plans funded below target levels.

The current rules encourage some plans to be chronically underfunded, in part, because they shift potential losses to third parties. This is what economists refer to as a "moral hazard." Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in some situations, even make new benefit promises, while pushing the cost of paying for those benefits off into the future. For this reason, some companies have an incentive to provide generous pension benefits that they cannot currently finance, rather than increase wages. The company, its workers and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan, then by other plan sponsors in the form of PBGC guarantees. Under our proposed funding rules, financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they fund them in a reasonably timely manner.

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

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

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

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

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

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

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

Improving Disclosure to Workers, Investors, and Regulators

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

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

For example, the principal Federal source of information about private sector defined benefit plans is the Form 5500. Schedule B, the actuarial statement filed with the Form 5500, reports information on the plan's assets, liabilities and compliance with funding requirements. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, regulatory agencies are not notified of the plan's funded status for almost two years after the actual valuation date. If the market value of a plan's assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

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

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

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

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

The Bush Administration's Proposal

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

Provide broader dissemination of plan information.

Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, except for the information subject to Freedom of Information Act protections for corporate financial information, which includes confidential "trade secrets and commercial or financial information."

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

Provide more meaningful and timely information.

The President's proposal would change the information required to be disclosed on the Form 5500 and SAR. Plans would be required to disclose the plan's ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

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

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

Reforming Premiums to Better Reflect Plan Risk and Restoring the PBGC to Financial Health

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

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

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

The Bush Administration's Proposal

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

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

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

Conclusion

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

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

Chairman CAMP. Thank you for your testimony. Now we will proceed to questions. Mr. Warshawsky, it is clear the funding rules haven't met the goal of ensuring that all defined benefit retirees receive the benefits which are owed to them. The Pension Funding Equity Act of 2004 (P.L. 108–218) temporarily replaced the 30-year Treasury rate with a new discount rate based on long-term corporate bond yield. Why would the Administration's proposed yield curve be a more accurate measure of liability, and has it been tested in any way that you can discuss with us?

Mr. WARSHAWSKY. Congressman, we believe the yield curve is a more accurate way of measuring the pension liabilities, as I indicated in my oral remarks. It is very common for any long-term obligation to be measured using a yield curve. Mortgages, for example, just in terms of thinking about a mortgage, you pay a different rate if you get a 15-year mortgage than if you get a 30-year mortgage because of the yield curve. Our proposal is no different in terms of having the date of the cash flows matched to the rates on the yield curve, and that is the most accurate measure.

We have published a paper which is up on the Department of Labor website and the Department of the Treasury website, which explains in great detail how the yield curve was calculated and how it might be applied in calculation of a pension liability.y.

Chairman CAMP. The Administration's proposal, a plan with older workers and retirees, would use a discount rate tied to bonds with shorter maturities than the long-term corporate bond rate. That would increase contributions by the plan's sponsor. Could you explain why that is more accurate for a plan that has short-term liabilities to use a short-term discount rate to calculate those liabilities?

Mr. WARSHAWSKY. Congressman, in our paper, we in fact measured two different plans: one which was a plan that was mature, that had older workers; and another which was a younger plan which had younger participants. In fact, there was a modest but significant difference, in terms of the measurement using a yield curve, as opposed to using one interest rate. Basically, we feel as if using a yield curve is a more accurate measure. If the plan needed to terminate, the rates that it would get in the insurance market would reflect the maturity of its liabilities. This is a more accurate measure.

Chairman CAMP. Mr. Belt, some would argue that improving the pension funding rules would actually result in better-funded pensions, and therefore, the Administration's proposal to increase the PBGC premiums wouldn't be necessary. Do you believe that funding reform alone is enough to reduce the deficits of the PBGC?

Mr. BELT. I think it needs to be a combination of the two because of the incentive effects as much as anything else, Mr. Chairman. The first goal should be to get money into the plans. No question about that. That is where benefits are—if resources are there to pay the benefits that have been promised, participants won't suffer any loss nor would the pension insurance program. Inevitably, there will be some losses. Any insurance program is designed to incur some losses, and premiums need to be set at a level that are sufficient to cover the expected claims. That is our only source of revenue. We are supposed to be self-financing under the statute. We need to have premiums at a level that is sufficient to cover expected claims. Clearly, the emphasis should be on the funding rules. Right now, we have the wrong incentives. Historically, looking back over the last 10 years, premiums at the PBGC have averaged about a billion dollars a year. They have trended up just in the last year or so, but about a billion a year. Our net position has changed by $30 billion, just over the last 3 years. Clearly, premiums have been dramatically insufficient to cover expected claims, which is not a sustainable business model if we are supposed to be self-financing.

Chairman CAMP. Thank you very much. Mr. McNulty may inquire.

Mr. MCNULTY. Thank you, Mr. Chairman. There are a couple of Members on both sides of the aisle that didn't make it yet, and I would ask unanimous consent that we follow the usual procedure and allow them to submit questions in writing.

Chairman CAMP. Hearing no objection.

Mr. MCNULTY. I want to thank all of the witnesses. Director Belt, the PBGC's financial status went from a surplus to a deficit in 4 years. I would like you to describe briefly, especially for the Members who weren't here when you gave your testimony, the main reasons you think that happened, and what is the single most important step we can take to ensure that does not occur—that precipitous downturn doesn't occur in the future.

Mr. BELT. As to the second question, I hope this isn't too glib, Congressman, but enact the Administration's reform proposal. As to the first question, it is really a combination of factors, and I think a recent study done by Credit Suisse First Boston, an investment banking firm, is very informative in this regard. The study looks at the pension plans of the companies in the Standard & Poors (S&P) 500—the 350 or so of those that sponsor pension plans—which account for the significant majority of pension assets in the system. They noted, or found, that from 1999 to 2003, total assets increased by just $10 billion for all 350 pension plans. During that same period of time, liabilities increased by $430 billion, and that is why we see the wide gap that we do. The problem, in addition to that, is companies were taking advantage of low minimum requirements during the boom years of the 19nineties, and occasionally putting in modest additional amounts and generating credit balances. As a result of those credit balances, the companies were avoiding making any contributions over the last several years. That has been the case in plans that we have taken over and terminated: U.S. Airways, Bethlehem and others. It has been a combination of factors. Benefits continued to accrue. They weren't putting in that much cash in the pension plans, sometimes not at all. The liabilities were growing because interest rates were coming down and asset values were falling, but they still had to pay out benefits as well.

Mr. MCNULTY. Let me give you a chance to respond to testimony that is going to occur after you leave the panel—the second panel—because some people are going to come before us today and testify that enacting the President's proposal, as you have suggested, will result in many companies terminating their plans or freezing benefits. How would you respond to that?

Mr. BELT. I would first note, Congressman, that is what is occurring under current law. We have seen a diminution——

Mr. MCNULTY. Why would that not be exacerbated? They are going to say that would be exacerbated by enacting the President's plan.

Mr. BELT. I appreciate that that argument has been advanced. We would respectfully disagree with that conclusion. I certainly understand that companies, under current law, want the flexibility to make additional contributions on a tax-favored basis when they choose to do so—notwithstanding the fact that the evidence is that they haven't done that on a sufficient basis to fully fund their pension plans. I understand that they want the flexibility to not make any contributions in a given year and take advantage of those credit balances, should they choose to do so—notwithstanding the fact that they have to write a check for wages, for health care, and for defined contribution plans. They look at defined benefit plans a little bit differently—as a free lunch—and that is what happened during the nineties. I understand that they want the flexibility to have a fee put to the government—to the taxpayer—which is what the current system allows. Our view is that is not the responsible way to manage a defined benefit system in the pension insurance program. They also can't, willy nilly, leave the system for two reasons: one, a lot of their agreements—in many cases, their pension plans are covered by collective bargaining agreements, so they have to deal with labor on those issues. Second, they are pricing those liabilities at a fairly high level. If you are going to do a standard termination, you have to go out to the annuity market. What we talked about is $450 billion of system funding. If they all wanted to exit, they would have to write $450 billion worth of checks, and I am not sure they would be willing to do that.

Mr. MCNULTY. Mr. Warshawsky, could you delineate what parts of the President's reform package are revenue raisers and which ones are revenue losers?

Mr. WARSHAWSKY. Congressman, the funding rules that we propose result—my recollection is—at a revenue loss of $3.7 billion over 5 years. The premium increase—the premium increase and the new structure of premiums—results in an increase, my recollection is under the Administration's estimates, of $15 billion.

Mr. MCNULTY. Thank you, Mr. Chairman, for letting me go over a couple of minutes.

Chairman CAMP. Thank you. Now Mr. Foley may inquire.

Mr. FOLEY. Thank you, Mr. Chairman. I think, if I closed my eyes, we could be talking a number of things—Social Security and the shortfalls we have in that system, Fannie Mae, Freddie Mac with transparency. When you look at a stock price of a company, oftentimes pension liabilities is what drags down the stock because investors know they haven't fully funded. When you look at the airlines, it was easy to put those responsibilities on your lap, and that is through the mechanism of bankruptcy. If you go to bankruptcy, you inherit their plans.

Mr. BELT. It sometimes seems to be that easy, but there is a process under the law, once they enter Chapter 11, to file with the bankruptcy court, an application for distressed termination of the pension plans.

Mr. FOLEY. What would keep a company from—if I look at my balance sheet and I realize I have these current cash flow needs and I can't even pay existing employees, and I look at the pension, if I could put that liability off to you—go into a quick Chapter 11 and move myself out? I have taken away billions of liability from my corporate balance sheet. I may have not been as healthy because I have to declare Chapter 11, but I restructured, moved a liability and moved forward. It seems that the enormous burden is on your enterprise.

Mr. BELT. You have hit the nail on the head—with respect to the issue that I address in my testimony—the moral hazard that exists in this system. There are perverse incentives to be able to shift costs that one has taken on volitionally onto third parties, and that is what we have seen happening in more recent instances. The concern is also that it has become almost a business strategy. It certainly gives me concern when I see airline executives—and I understand where they are coming from, and I appreciate the challenges they are facing—they say my competitor—one of my biggest competitors—is able to shift a substantial portion of their labor costs, then I am going to feel competitive pressure to do the same thing. Every one of the legacy carriers, outside of bankruptcy, their chief executive officer has stated that publicly.

Mr. FOLEY. It is not just those corporations. I guess that is my bigger concern than the transparency issue—Ms. Combs mentions about marking to market. It is amazing you would have a 2-year-old reporting lag from being able to define your own asset-liability class. That is amazing to me, to not have to state your assets accurately quarter-to-quarter—never mind waiting 2 years to disclose what could potentially be huge insolvencies.

Ms. COMBS. It is worse than that. The reporting lag is 2 years, but the assets and the liabilities are each smoothed over 4 years. They are able to, on their assets, smooth them as if they were earning what they had been earning in the past, as opposed to marking them to market to have a realistic picture. That is what we want to correct, so that people have accurate information, and can plan accordingly.

Mr. FOLEY. Is there anything in law that is a penalty for corporations just to do what we have described?

Mr. BELT. There are legal requirements to meet the minimum funding obligations, but the problem is those requirements are too lax. The companies that have come to us that have terminated their pension plans—and United Airlines's brief that was filed in bankruptcy court, takes some pride in noting the fact that they complied with all of the internal revenue funding rules. Notwithstanding that fact, they are more than $8 billion under-funded at this time, and could present a claim to the pension insurance program with more than $6 billion. That is, complying with the current set of funding rules.

Mr. FOLEY. I just applaud the effort. First, we have to have a very solid system. Second, if we are not matching assets and liabilities correctly, you will never have the correct financial footing. Third, if you are not marking the market, it sounds nice that you may think your asset in the bank is X, but if it is not, you shouldn't be allowed to continue to call it X.

Chairman CAMP. Thank you. Ms. Tubbs Jones may inquire.

Ms. TUBBS JONES. I am particularly concerned about United Airlines because my father is an 84-year-old retiree, my sister is a retiree, my brother-in-law is a retiree, and my niece is a flight attendant. I would appreciate you pay attention to what is going on at United Airlines and make sure they stay. It is personal, you know.

Mr. BELT. I stay awake many nights.

Ms. TUBBS JONES. I didn't get to give an opening statement, and I apologize for the delay in my arrival, but I am particularly concerned about the need that we have defined benefit pension programs for our workers. As important is the ability that employers have to keep defined benefit plans by establishing cash balance plans. These plans are very important to my congressional district. I come from the 11th Congressional District of Ohio. Huge deal, huge manufacturing area. The four largest employers in my district provide their workers with cash balance plans. They are National City Bank, the Cleveland Clinic Foundation, Key Bank, and Eaton Corporation. These plans are important because of the plan, but, however, they may not keep their pension plans if we do not give them clear guidance on cash balance plans. Let me ask the representative of the Department of Labor, what role—excuse me, do you think cash balances should play an important role as Congress works on pension reform?

Ms. COMBS. We do, Congresswoman. The Administration is urging Congress to clarify the law regarding cash balance plans because we believe that they are an important option that should be available to employers.

Ms. TUBBS JONES. Have you suggested to Congress any ways in which to clarify that law?

Ms. COMBS. The Treasury Department has a proposal to deal with some of the issues that arise when a traditional defined benefit plan is converted into a cash balance plan. I defer to my colleague from Treasury to describe.

Ms. TUBBS JONES. He was my next person.

Mr. WARSHAWSKY. Glad to follow up. The Treasury Department has put forward a legislative proposal for cash balance plans. In fact, we had one last year and we are renewing it this year in the budget. It is entirely consistent with, I believe, your understanding that these plans do represent a viable defined benefit-type option to be offered to employees and the legal uncertainty that currently exists is preventing other employers to choose that option that might want to do so and may even be causing some planned sponsors——

Ms. TUBBS JONES. What is the upside of the cash balance plans?

Mr. WARSHAWSKY. The upside is that for many employers, particularly that have young work forces, it is a way of providing incentives for—that provide a guaranteed return on the contributions but yet enable workers—if they leave the company early, to get that benefit and roll it over.

Ms. TUBBS JONES. What is the downside?

Mr. WARSHAWSKY. I think it is a reasonable approach. If it is understood to be an exchange between the work force and employer, I don't see a big downside.

Ms. TUBBS JONES. I would appreciate some movement on your Department's push to get some of these issues resolved. There is probably some movement due on our part as well. Since you are in the position to help set the policy on that, I would appreciate some further movement on that. Mr. Chairman, thank you.

Chairman CAMP. Thank you. Mr. Linder may inquire.

Mr. LINDER. How many companies did you say have benefit plans, Mr. Belt, that you oversee?

Mr. BELT. There are about 30,000 single-employer defined benefit plans right now.

Mr. LINDER. What is the total asset value of those plans?

Mr. BELT. Somewhat north of a trillion dollars.

Mr. LINDER. How much do they pay you in premiums every year?

Mr. BELT. Historically, last 10 years, has averaged about a billion a year.

Mr. LINDER. What do you do with that money?

Mr. BELT. We pay the benefits to employees, to the participants in plans that we have taken over.

Mr. LINDER. Do you invest some of that money?

Mr. BELT. We also invest not only the premium revenues but also the assets that we take over in plans that we trustee. We are paying about $3.5 billion a year now in benefit payments, which exceeds the amount of premium revenues that we have been collecting. I would note that.

Mr. LINDER. How much of those assets are in legacy airline carriers?

Mr. BELT. I don't know how much—I guess it would be—our total exposure to the airline industry at the end of last fiscal year was $30 billion. I think it was about $20 billion in assets and $50 billion in liabilities. We can get you those figures for that. It is in that range.

Chairman CAMP. Thank you. Mr. Larson may inquire

Mr. LARSON. Thank you, Mr. Chairman. I also apologize to my colleagues for arriving a little late, and thank our panelists for your service to our country. My question is a follow-up question to that Mr. McNulty asked, and I will direct it to Mr. Belt. You said at least—and I want to make sure I am understanding this correctly—that when Mr. McNulty talked about the next group of panelists coming on board and people from the business community directly talking about the problems that they are going to face inasmuch as they deal with this on a regular basis. You said you don't believe that is true or that that is going to happen. You don't believe that is going to transpire. Who is right?

Mr. BELT. I certainly hope we are right in two respects. Number one, as a policy matter, I think it is critically important from the Nation's standpoint that we have a stable source of income for millions of workers and retirees. If I put on my business hat in administering the pension insurance program, the last thing I would want to do is chase away my principal revenue base. As a business matter, since we are supposed to be self-financing, my principal source of revenues is premiums, I don't want them to X the system. We tried to strike an appropriate balance here in addressing the risks that exist under the current system to participants, to other premium payers, and to the taxpayer to try to incent and provide incentives for companies to be able maintain the pension plans. Not only maintain the pension plans, we would like to create the legal and regulatory environment which provides incentives for new entrants to come to the system. Just like tax policy you all adopt every day, we want to actually try to broaden the base so we can lower rates. We can't do that without resolving issues with respect to cash value plans, rationalizing premiums, and strengthening the funding rules.

Mr. LARSON. I am looking forward to their response as well, because it seems we are at a very specific impasse here, where you don't believe it is going to happen, and they are concerned that these very policies will lead to exactly what you believe will not happen, and you state appropriate reasons why. My question is for Ms. Combs. What kind of relationship do you think that all of this bears on Social Security? Some of us are concerned as we look at this three-legged stool of pensions, personal savings, and Social Security. Does it make an awful lot of sense to introduce more elements of risk into Social Security?

Ms. COMBS. These are parallel provisions. As you say, there are the so-call three-legged stool of retirement security and all of those stools are under stress. As the population ages, these institutions are facing a lot of pressure. I think it is very important that we secure both Social Security by modernizing it, and by making it a strong and stable system for younger workers.

Mr. LARSON. Does that mean privatizing accounts?

Ms. COMBS. The President has been very clear he would like to make sure that everyone aged 55 and older will be under the current system, but younger workers should be given an option——

Mr. LARSON. Does privatizing introduce more risk?

Ms. COMBS. It is not privatizing the system, but you are having a personal account supplement their Social Security benefit. Equally, we need to stabilize that second leg of the retirement stool, which is the private pension system.

Mr. LARSON. Which is more in a greater crisis, Social Security or savings and pension system?

Ms. COMBS. I think we need to address both of these issues. I think that it is very important as our population ages and as people are looking forward to retirement, that they have confidence in a secure retirement. That means a strong and stable Social Security system. It means adequate pensions that are secure—that will be there for them when they retire—and it means opportunities to have personal savings so that they can supplement those programs. I think it is vitally important we address these issues now as our population ages, and we prepare to provide a secure retirement for our workers and retirees.

Mr. LARSON. Wasn't the logic behind Social Security that we should have a guaranty with that leg of the stool—that it will provide the floor from which people could not fall through? Do you think that especially since we are having so much trouble in the area of pensions and with personal savings that, at least minimally, the government ought to guarantee the public that it is going to be there for them, and not subject that to even greater risk?

Ms. COMBS. The Social Security would remain. The President's proposal is to strengthen and shore up the Social Security system so it is there.

Mr. LARSON. Inasmuch as we haven't seen the President's proposal and inasmuch as it is a concept, I guess that I can't criticize you or the plan. It seems to me, when you have the proposed plan that exists out there, that is a cut of more than 40 percent in people's benefits, that this is going to make it awfully difficult for people, especially when we see what is happening to their pensions and personal savings.

Ms. COMBS. I think the President has been very clear that he is open to all sorts of suggestions, and wants to get a dialog going about how to do this—and believes that personal accounts should be part of an option for some younger workers who choose to participate in them going forward. Beyond that, he is open to discussion and suggestions from Congress to move this very important debate forward.

Mr. LARSON. We are not going to see a plan from him.

Chairman CAMP. The gentleman's time has expired. Mr. Chocola.

Mr. CHOCOLA. Thank you, Mr. Chairman. Thank you all for being here today. Ms. Combs, you talked about risk-based premiums. Is that based on the amount of their unfunded liability or their creditworthiness or both?

Ms. COMBS. It is based on the combination of both. It is the amount of underfunding in the plan—its assets versus its liability target. Because the plan's—the financial status of the plan's sponsor factors into what the funding target is, it de facto becomes part of the amount that they owe on the premiums. It is the amount of underfunding and the risk of the plan's sponsor's failure that would then establish the amount on which the premium would be assessed.

Mr. CHOCOLA. Is that the same thing as current variable premium, or is it different?

Ms. COMBS. It is different. The current variable rate premium is $9 per $1,000 of underfunding. It merely measures the underfunding. It doesn't take risk into account. It is keyed to a much lower funding target—only 90 percent of current liability. As a result, only 10 percent of underfunded plans have paid a variable rate premium. In the last year, that has been a little bit higher, closer to 18 or 20 percent. Under our proposal, we would have every underfunded plan pay a risk-based premium. By spreading out the base to more plans, we believe we could keep the rate itself relatively constant. We just spread it over a much broader base.

Mr. CHOCOLA. Are those loopholes that only 10 percent is paying in, or are they addressed in the reform?

Ms. COMBS. They are addressed in the reform. The current law allows them to do that because the target against which they measure underfunding is so weak. Therefore, we do make it a much tighter target that all underfunded plans would pay based on 100 percent of their funding target.

Mr. CHOCOLA. Mr. Belt, could you give us an overview of how you view the increased premiums and how they are going to address the solvency of the PBGC?

Mr. BELT. The premium levels embodied in the President's budget proposal would compensate for past losses, the $23 billion deficit over a longer period of time, a 10-year amortization period, as well as expected claims going forward. An insurance system to be viable over the long-term needs to have premiums that are set at a level sufficient to cover expected claims, and that is what this premium proposal does.s.

Mr. CHOCOLA. At what point does it become solvent?

Mr. BELT. It would be over 10 years.

Chairman CAMP. Thank you. I want to thank the panel for your testimony. Obviously, any written statements will be made part of the record. Thank you very much. I am sorry. I forgot Mr. Weller would like to inquire, if you wouldn't mind staying a little bit longer.

Mr. WELLER of Illinois. Thank you, Mr. Chairman. I apologize for being tardy and arriving late. I certainly will do my best to be on time next time. I want to thank the panel for being here. I will be somewhat brief. I represent a district which is both steel-producing as well as a steel-consuming district. A few years ago, our steel production was essentially on the ropes and we had a lot of workers laid off and a lot of companies were going under in the south suburbs of Chicago. Steelworkers were worried about their benefits, worried about their pensions. Thanks to the President's decision to limit imports temporarily, we are now seeing a big turnaround in steel production in my region and jobs are returning. The question still is out there about these workers who work for bankrupt companies, whose pensions were perceived to be in jeopardy by both their union, as well as the rank and file. I was wondering, Mr. Belt, could you tell us the status of your agency's work with the steelworker pension funds and bring us up to speed?

Mr. BELT. As you know, we have taken over the pension plans of a good portion of the steel industry, RTI, Wheeling, Weirton, LTD, and others. PBGC stands behind that. We are actually cutting the benefit checks—pension benefit checks—for tens of thousands, if not hundreds of thousands, of your constituents in the steel industry, workers and retirees, right now. We sent out 500,000 benefit checks a month, total annual payments of $3.5 billion. Those are those 500,000 in pay status. There is another 500,000 deferred vested that will start drawing benefits.

The problem, and the real tragedy, is that many workers had their expectations of secure retirement dashed because they suffered significant cutbacks in the benefits—that were promised under their pension plans—because the PBGC, by law, does not guarantee all benefits that are promised under a pension plan—

particularly for somebody that is already retired and was drawing on their pension benefits from the company. If the company declares bankruptcy, we may have to tell them that they are going to get a substantially lower check in the future, which is the real tragedy in this entire system. It is now about the workers and retirees.

Mr. WELLER of Illinois. Mr. Warshawsky, Mr. Secretary, how will the President's initiatives in his budget be of benefit to workers in this type of industry, which, of course, has suffered some big challenges in the last few years? It has been reorganizing in order to compete in the global economy. How do you see the initiatives you have been outlining before us being of benefit to the workers in my district or workers in the steel industry?

Mr. WARSHAWSKY. We believe the benefits of this reform proposal will apply to the steel industry as they apply to other industries as well. One is to be sure that the plan is adequately fully funded over a reasonable period of time. That is probably the most important aspect, which basically would prevent the type of problems that Mr. Belt referred to from termination of plans. Second thing we feel is very important—that the planned participants know the funding status of the plan and get an accurate measure of both assets and liabilities. Our proposal would do exactly that. In addition, in order to have a viable system, and in order for employers to have the incentives to fund their plans, in good times as is currently being experienced by the steel industry—steel companies—enables companies to put in more money than current law allows in order to smooth out the volatility which naturally comes from the business cycle. We feel this is a very important, and, I would note, a wildly lauded aspect of our proposal, which, however, has to be put in the context of the whole proposal. I think this would benefit those companies as well.

Mr. BELT. I forgot to mention the most important point. Since we are responsible for paying the benefits of your constituents as long as they are alive, it is critically important that PBGC's long-term financial viability be addressed so we are able to stand behind our guaranty. Without something like the President's proposal, we are not going to be able to do that. Current law is an unsustainable path.

Mr. WELLER of Illinois. Thank you.

Chairman CAMP. Thank you. I would like to thank the panel for their testimony. We will now have the second panel including Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries; Mr. Christian Weller, Senior Economist, the Center for American Progress; and Mr. Henry Eickelberg, Staff Vice President, Human Capital Processes, General Dynamics Corporation. I want to welcome the panel today and you may begin. Mr. Gebhardtsbauer, your written statement will be made part of the record and you have 5 minutes to summarize your testimony.

STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES

Mr. GEBHARDTSBAUER. Thank you Chairman Camp, Ranking Member McNulty, and distinguished Committee Members. Thank you for inviting us to testify on the President's proposal to reform funding. My name is Ron Gebhardtsbauer and I am the Senior Pension Fellow at the American Academy of Actuaries. We are the nonpartisan professional organization representing all actuaries in the United States. I presented you with a paper with our comments on the proposal and will just talk about the most important issues.

The Academy is encouraged that the Administration has taken significant steps in framing pension reform. The recent proposal reflects many of the funding reform principles discussed in our paper. In particular, the Administration's proposed use of one funding rule and one amortization period improves transparency and simplicity. Flexibility is enhanced by their provision to increase the maximum deductible contribution. However, while the Administration's use of one funding rule eliminates a funding cliff, and that is helpful, their proposal would increase volatility anyway due to requiring the use of market assets and only 90-day averaging of interest rates. For example, if these rules were in effect in the past, minimum contributions would have more than doubled in 1986, when interest rates decreased by 300 basis points all in 1 year. They would have also doubled contributions the very next year, after 1987's October crash in the market of 33 percent, 2 years in a row where contributions would double and then double and then double again. Even 2-year weighting of interest rates would not have avoided this problem. Thus, our number one concern with the Administration's proposal is that it can create volatile and unpredictable minimum funding requirements, and that could cause many employers to decide their only viable alternative is to freeze or terminate their pension plans. That would have negative repercussions, not only for employers and employees, but also for the Nation's retirement security, the markets and the PBGC. This outcome must be avoided.

One way to fix the Administration's proposals would be to place a cap on large increases in the minimum contribution. It could be constructed to get assets to reach the funding targets just as quick as the Administration's goal. Otherwise, other ways to reduce volatility would be to average funding ratios or smooth assets and liabilities more than 2 years. In addition, without smoothing, the Administration's proposal would make other pension rules volatile, such as the PBGC premium and benefit restrictions. These problems could be fixed also so that the penalties are not triggered until the plan has been funded below this threshold more than 2 years in a row.

We would also give employers the opportunity to cure the deficiency before the penalty went into effect, which would help employees and employers. Our second issue is that we would suggest that the Administration retain the credit balance provision, but with modification. Minimum contributions can be significantly higher in difficult times and zero in good times. This is very hard on employers and exacerbates the cyclical nature of our Nation's economy, so that not only it hurts the employer, it hurts the Nation's economy. Credit balances encourage employers to contribute more in good times, which allows employers to better manage their financial resources. Eliminating the credit balance would create a disincentive for companies to contribute anything more than the minimum required contribution. However, there is a problem we would acknowledge with the credit balance rule. It could be fixed by growing it at the same rate as the plan assets. With this one fix, the credit balance provision will be a positive part of funding reform.

Our third concern deals with—under the principles of incentives to fund the plan and flexibility, we note that the Administration's provisions to increase deductible amounts will allow plans to build a good funding cushion, resulting in better funding of pension plans after market declines. However, it will not work unless employers can get an economic value if the returns are better than expected. For example, Congress could allow employers access to a plan's super surplus that is above a high threshold for other purposes, such as employee health insurance.

Our fourth and last point is that most of PBGC's $23 billion deficit is from probable terminations, and they might have been avoided or reduced if we allowed PBGC to work out pension financing deals with weak employers instead of PBGC having to take over their pension plan—which is the only thing they can do right now under current law. This would be more workable under the Administration's proposal to freeze benefits and freeze guarantees when companies enter bankruptcy. It would be valuable for Congress to make this fix soon along with enacting a permanent interest rate. The American Academy of Actuaries is ready to help on these important issues. Thank you for this opportunity to speak.

[The prepared statement of Mr. Gebhardtsbauer follows:]

Statement of Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. An Analysis of the Administration's Single Employer Pension Funding Proposal

The Pension Practice Council of the American Academy of Actuaries is encouraged that President Bush's administration has taken significant steps in framing pension funding reform. A healthy defined benefit (DB) system is essential to the financial security of our nation's retirees. The administration's recent proposal reflects many of the funding reform principles discussed in our paper, *Pension Funding Reform for Single Employer Plans;* namely: solvency, predictability, transparency, incentives for funding, flexibility, avoidance of moral hazards, and simplicity. In particular, their proposed use of one funding rule and one amortization period improves transparency and simplicity. Flexibility is enhanced by their provision to increase the maximum deductible contribution. In addition, they eliminate rules that currently allow sponsors of underfunded plans to avoid paying contributions and variable premiums.

However, the proposal may cause employers to decide their only viable alternative is to freeze and/or terminate their pension plan due to concerns that their minimum required pension contributions could become too volatile and unpredictable.[1] Plan

[1] The administration's use of one funding rule eliminates the DRC funding cliff, which is good, but it would increase volatility anyway due to requiring the use of market assets and only 90-day averaging of market interest rates. For example, equities declined by 33 percent in October of 1987. That could have doubled an employer's minimum contribution. In addition, if only 90-day averaging were in use in 1982 and 1986, the interest rate would have decreased by about 300 basis points in those two years, which could have more than doubled an employer's min-

Continued

terminations would have negative repercussions for national retirement security, the markets, employee morale, the Pension Benefit Guaranty Corporation[2] (PBGC), and an employer's ability to manage its workforce. This outcome can be avoided. In this statement, we identify how some of these concerns can be addressed to ensure a strong pension system.

Solvency

Funding targets: The administration's proposal sets a funding target of 100 percent of accrued benefits and increases the funding target if the credit rating of the plan sponsor falls below investment grade status. However, the additional funding to the administration's "at-risk" liability may be too late, because a company may already be too weak to make the additional contributions. Unfortunately, healthy companies may balk at funding to the higher "at-risk" liability because the additional funds may never be needed, nor could they be accessed without paying prohibitive taxes of over 90 percent.

Funding margins: Rather than creating a different structure of liability calculations for companies with low credit ratings, Congress could devise a set of funding rules that naturally lead toward the creation of a funding margin. For example, once the funding level exceeds the initial target liability, a minimum contribution (e.g., the normal cost) could be required until assets reach the "at-risk" liability or the accrued liability with salary projection (as in current law). This would create funding margins, which are what kept traditional salaried plans so much better funded than hourly plans in the past; encourage funding discipline; and avoid the need for ratings. Alternatively, the normal cost could be phased out by $1 for every $5 of surplus instead of for every $1 of surplus as in the administration proposal. This would also build a funding margin and help the employer avoid volatile minimum contributions.

At-risk liability: The administration's proposal determines the funding target for weak companies using an assumption that all employees will retire as soon as possible.[3] However, this may not represent the most valuable benefit. For example, in many pension plans, the earliest possible benefit is payable at age 55, while a much more subsidized retirement benefit may be payable at the employee's 30th year of service, which might occur at a later age. If this subsidized benefit occurs soon after age 55, the employee may very likely delay retirement in order to the get the subsidy. Fortunately, the administration proposal would require the use of the actuary's best estimate of the liability, if it is greater than the prescribed liability. This may solve the problem of potentially undervaluing the at-risk liability.

Assumption setting: History has shown that using the law and regulations to specify actuarial assumptions has not been successful, as evidenced by the delays in setting the discount assumption and the continuing debate on replacing the currently required 1983GAM mortality table. We recommend that the law allow actuaries to set the mortality assumption, since it differs by plan. The law and actuarial standards both now require each assumption to be individually reasonable, which is a major change from when Congress first started specifying assumptions. If there are concerns, then actuaries could be required to justify their assumptions in writing if they seem out of the ordinary.

Valuation dates: We do not understand why the administration's restriction on valuation dates needs to be imposed. If anything, it is hoped that more plans could use prior year valuation data[4] (along with year-end market assets), in order for com-

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imum contribution. Some employers might decide to move more of their plan assets into bonds (to dampen the volatility of the plan's underfunding and thus the minimum contribution). However, surveys suggest that many employers have concerns that their contributions would increase too much due to lower expected returns on bonds, and that their employees would rather take their chances investing in the stock market in a defined contribution (DC) plan. Another option would be for employers to fund their plan more to create a funding margin (which could help employers avoid volatile minimum contributions), but this may not be widely adopted unless Congress relaxes the rules regarding access to surplus assets.

[2] The PBGC could lose their healthy premium payers, but not the weak employers with underfunded plans, because the latter would not be able to fund enough to unilaterally terminate the plan under applicable rules. In addition, under the administration's funding proposal, weak employers may still invest large percentages in equities but not build up funding margins to protect the plan from equity declines.

[3] They also add a loading factor to reflect the cost of purchasing a group annuity, even where a significant portion of the liability may reflect lump-sum payments.

[4] Liabilities a year later could be determined by adjustments for the accrual of benefits, the passage of time, and changes in interest rates and significant events, as is done when utilizing the alternative method for determining PBGC variable premiums.

panies and associations to budget in advance for their contributions and to disclose funded status information to participants in a more timely manner.

Predictability and Hedgeability

The administration's 90-day smoothing provision will cause problems for both sponsors of bond-immunized pension plans as well as sponsors of diversified stock portfolios. For the immunization sponsors, the 90-day smoothing provision will make it difficult for plans to hedge their liabilities, since bond prices will not rise and fall with liabilities using a smoothed discount rate. (They should be allowed to use market liabilities, just as they can now elect to use market assets.) For the diversified stock portfolio sponsors, 90 days does not provide enough smoothing to make contributions predictable. Their contributions will be volatile (and vary greatly depending on the date valued), unless there is some mechanism to reduce the volatility.

Contribution volatility: We suggested the creation of an anti-volatility mechanism (AVM) in the predictability section of our funding reform paper. It would place a cap on large increases in the minimum contribution, such as 25 percent of the normal cost, or 2 percent of the plan's accrued liability, if greater. It would enable faster elimination of underfunding than one might first surmise, because the effect is cumulative. Our analysis shows that the cap would rarely be applied more than three years in a row, and that assets could reach the funding target as quickly as the administration's proposal if desired. Other ways to reduce volatility would be to average funding ratios or smooth assets and liabilities.[5]

Reduce cyclical nature of minimum contributions with credit balance: Minimum contributions can be large in difficult times and small (or zero) in good times, which is very hard on employers and exacerbates the cyclical nature of our country's economy. Credit balances can fix this problem by encouraging employers to contribute more in good times, knowing that the excess contribution will enable them to contribute less in difficult times. Eliminating the credit balance would create a powerful disincentive for companies to contribute anything more than the minimum required contribution. For example, if they leave the money on the outside of the plan they get dollar-for-dollar credit for it when they use it to pay the minimum contribution in the following year. However, if they contribute it to the pension plan, they may not get any credit for it the next year because the amortization rules in the administration proposal are so one-sided. At most they would only get 1⁄7 of the credit. Thus, there would be a tremendous reluctance to take a chance on contributing an additional amount to the plan, if plan sponsors knew that they might need that cash to pay next year's contribution.

Some of the objections to the use of credit balances could be overcome by growing credit balances at the same rate that plan assets grow, instead of at the valuation rate. The other objection is that credit balances allowed several sponsors of distress-terminated plans to avoid contributions right before their plans terminated with insufficient funds to pay all benefits. However, with the above fix, the credit balance provision would only increase the assets in the plan. Taking advantage of a credit balance would only return plan assets back to where they would have been had the employer never contributed more than the minimum. Thus, the objective should be to make sure the minimum funding rules are strong enough, not eliminate the credit balance.

If there is still a concern that credit balances can eliminate contributions to underfunded plans, then a compromise rule could prohibit using the credit balance from offsetting the full contribution when a plan is underfunded. The underfunded plan could be required to pay the normal cost, unless it gets a waiver from the IRS, provides security, or freezes accruals.

Volatile plan desigh: abrupt freezing and unfreezing of benefit accruals will make plan administration and employee notification very difficult, will disrupt employee expectations, and will call on actuaries to estimate liabilities before employee data is available.[6] This problem is exacerbated by having to freeze benefits for certain plans if the actuarial valuation is not completed by a specified time—even if

[5] Smoothing interest rates over 2 years may not be adequate. For example, in 1986, a two-year weighted average of interest rates would have been just as volatile as the market interest rates, and the one-year average would have been more volatile (i.e., the one-year average changed by 350 basis points from January 1986 to January 1987).

[6] The Administration proposal requires actuaries to certify that the funded status of a plan exceeds a certain threshold within three months after the beginning of the plan year, in order to stop an accrual freeze. Typically the actuarial valuation is not complete by then, nor does the actuary have the data. If actual data later shows the plan is even more poorly funded, the retroactive effects on participants could be a cause for concern.

there is nothing in the plan's demographics or assets to indicate that the funding status has deteriorated since the prior valuation.

A remedy to this problem could be to require an accrual freeze only if the funding ratio is less than the threshold for two consecutive valuation dates, and to allow employers to cure the problem by a contribution or security after the first valuation showing a deficiency. Similar rules could also be provided for:

- the Internal Revenue Code (IRC) Sec. 401(a)(29) threshold requiring security for amendments; the 100 percent threshold for IRC Sec. 412(m) quarterlies and for having to pay the variable rate premium;
- the 125 percent threshold for IRC Sec. 420 transfers to retiree health plans; and
- the thresholds in IRC Sec. 412(c)(9)(B) which allows use of a prior valuation.

Congress should consider freezing benefits in *all* plans under the threshold (60 percent in the administration's plan), not just those of weak employers. This would encourage healthy employers to fund their plans when they can, and it avoids the need for the government to rate companies.

Eliminating lump sums will also disrupt employee expectations. It could easily cause a "run on the bank," which not only hurts the PBGC, but also the workers and retirees remaining in the plan. Ways to avoid this problem include:

- Increase the threshold for prohibiting lump sums to 100 percent of target liability (or more). There is less concern about a "run on the bank" in paying a lump sum when a plan is over-funded. Note: the current rules in the Code of Federal Regulations (CFR) 1.401(a)(4)-5(b)(3) already restrict lump sums for highly compensated employees (HCEs) or the top 25 when funding ratios are less than 110 percent. They could be applied to all HCEs.
- Keep the plan well funded, or require the plan sponsor to contribute the unfunded portion of the lump sum, in addition to the minimum contribution.
- Phase in the lump-sum ban by only allowing payment of the funded portion of the lump sum. For example, if the plan is 90 percent funded, pay 90 percent of the lump sum.
- Allow or require sponsors to eliminate the lump-sum provision without violating IRC Sec. 411(d)(6), as long as it is replaced by a 20-year certain and life annuity. (And allow insurance companies to pay the lump-sum value if the annuitant signs over the pension to the insurer).

Outlawing shutdown benefits in their entirety (as proposed by the administration) may not be necessary in cases where the plan's funding is adequate and/or plan sponsor can cover the increased benefits. These contingent benefits have been responsible for some of the most dramatic losses absorbed by the PBGC and present considerable funding challenges. However, they have also proved to be a valuable tool for workforce management in many circumstances.

Congress could consider a proposal that would allow a plan sponsor the option of eliminating these benefits without violating IRC Sec. 411(d)(6). For those employers who wish to retain these benefits, perhaps the following could be considered:

- Retain the ability to provide these benefits if, at the time of the shutdown, the plan is well enough funded to cover the incremental benefits.
- Treat the shutdown benefits as an ad hoc amendment, similar to an early retirement window, that would phase in PBGC guarantees from the date of the shutdown and trigger the proposed funding requirements. Under this scenario, incremental shutdown benefits would not be payable if the employer could not make the additional contributions required under the proposed rules.
- Increase the variable premium to reflect the liabilities that would be created by these benefits.Transparency

Transparency

Disclosure: We agree with the administration's proposal to require more timely and meaningful disclosure of trends in funding ratios, and in fact, would go further. We would require year-end disclosure for all plans. We would also suggest requiring a breakdown of plan assets by equities, bonds (long, medium, short, and government vs. corporate), and other assets to help participants project funding ratios from the most recent information. This is already required on an aggregated-plan basis for financial statement disclosure, so this should not require much additional effort for plan sponsors. However, we would not require disclosure of the at-risk liability for plans of healthy sponsors, since it would not be relevant and could mislead participants.

Earlier Schedule B actuarial information: The administration's proposal would require the Schedule B earlier for plans with more than 100 participants. As noted above, we would include year-end asset information and estimates of year-end liabilities, since similar calculations are already performed for accounting statements and variable premiums (using estimates for significant events). We would also suggest applying this disclosure rule to all plans, regardless of size, as long as estimates can be used. However, we would not require information on the funding standard account until the final contributions are made, which can be up to 8 ‡ months after the end of the plan year.

PBGC guarantees: We would also suggest simplifying PBGC guarantees (as discussed in the transparency section of our funding reform paper) so that the Employee Retirement Income Security Act (ERISA) Sec. 4011 notice to employees, which discloses benefits that would be lost if their pension plan terminated in distress, is more understandable.

Incentives to Fund; Flexibility

Expanding asset transfer rules: Increasing deductible amounts as provided in the Administration proposal will help us have better funded plans after market declines.[7] [8] However, it will not work unless employers can access a plan's super surplus (above a high threshold) to use for other purposes, such as other employee benefits. Otherwise, employers will be reluctant to take a chance on contributing additional amounts that may later be inaccessible. While some employee advocates have concerns about this issue, we think it can be constructed in a tight enough way to benefit the employees, while at the same time addressing the concern that the pension plan could be insufficient someday. See the discussion on this in our funding reform paper.

Retain credit balance provisions: The credit balance provisions provide incentives to employers to contribute more in good years. (See the earlier discussion on reducing the cyclical nature of minimum contributions with credit balance.) In addition, plan sponsors who accumulated credit balances in good faith under the current rules with the expectation that they were building a cushion for use in future years should not lose that promise.

The administration's proposal to preclude funding of nonqualified deferred compensation (unless the employee pension plan is similarly funded) is an attempt to encourage sponsors to fund the employee plan. However, we don't think it will work, in part because amounts funded for nonqualified deferred plans are already subject to creditors' claims and would generally be forfeited if the qualified plan fails. A real incentive would be to securitize a mirror nonqualified plan to the extent the employee qualified plan is funded, as discussed in the incentives to fund section of our funding reform paper.

Avoid Moral Hazards

Risk-related premiums: The administration's proposal changed the rules for determining the risk-related premium by requiring the earliest retirement age assumption for weak companies, and by using the same discount rate as for funding. In addition, the full funding limit (FFL) exemption is gone, so employers will not be able to avoid paying a variable premium as in the past—unless they are 100 percent funded.

However, we are concerned that the administration's proposal lets the PBGC board set the premium rate and funding policy without limits, and without any input from its premium payers. For example, the PBGC board could decide to set the premium at an amount that would require the remaining DB plans to quickly pay for all of the PBGC's past underfunding. This would require a premium that is greater than is actuarially required from the remaining plans that have not abused the PBGC. Since Congress has never clearly stated whether the PBGC should be funded like an insurance company, a pension plan, or a pay-as-you-go government agency, this rule puts that decision in the hands of the Board without any input from Congress. At a minimum, Congress should set limits on how large the premium increases can be and how well PBGC should be funded. In addition, we

[7] In 2002, many plans could not deduct their unfunded ABO at year-end, even though they wanted to. The administration's proposal can be very helpful here.

[8] The administration might consider increasing the maximum deduction to 150 percent of their target liabilities (which are based on corporate bond rates), since the current rules allow deductions using 90 percent of Treasury rates. However, this idea would have to be balanced with revenue concerns. We also suggest that the administration consider repealing the combined plan limit. At a minimum, it should use 130 percent (or 150 percent) of liabilities to conform with the administration's revised rule for DB plans, and it should eliminate the excise tax for non-deductible contributions, since the reversion excise tax is sufficient for employers to not make excess contributions. See these and other ideas in our paper on maximum contributions found at http://www.actuary.org/pdf/pension/deduct_letter_051404.pdf

note that it is better for Congress to tighten the funding rules than for the PBGC to increase premiums.

PBGC could avoid some distress terminations: The administration's proposal freezes benefits and PBGC guarantees when employers enter bankruptcy. With these powers, the PBGC's losses are limited. We suggest, therefore, that the PBGC could be given the authority to work out pension financing deals with employers, without having to threaten plan termination its only recourse under current law. This will be especially important if PBGC cannot get (1) higher priority in bankruptcy for its missed contribution claims or (2) the ability to perfect its liens against companies in bankruptcy.

Simplicity

Yield curve: The administration's proposal generally provides simpler rules. One exception is their requirement to use a corporate bond yield curve. While we appreciate the theoretical value of using a yield curve and could adjust our models to incorporate this, a cost-benefit analysis will show that, in practice, the yield curve complicates valuation and lump-sum calculations without adding meaningful accuracy.

For example, using a yield curve will not change the liability, except on a very mature plan during the few times when the yield curve is steep. And it will change the liability by only a small amount (e.g., 3 percent, which would only increase liabilities from $10 million to $10.3 million). At the same time it will decrease the liability for a very young plan, so it may not increase the PBGC's variable premium income by much at all. Furthermore, requiring more accuracy for the discount rate, while prohibiting more accuracy on the mortality table, is not consistent. It is interesting to note that using collar mortality differentials would be enough to undo the small differences created by using yield curves. Thus, Congress should give regulators the ability to simplify the yield curve calculations, if they find it less valuable than initially thought. Note that the PBGC itself originally used a yield curve for multi-employer calculations, but replaced it with the simplified method they use for single employer plans.

Furthermore, the yield curve won't work for the portion of a plan's assets invested in Treasury bonds. Recent experience has shown that Treasury bond prices can increase when corporate bond prices decrease, and vice versa.

In addition, although the proposal phases in the financial effect of the yield curve over a three-year period, it requires that actuarial valuation systems be revised to accommodate these calculations in time for the 2006 valuation. We suggest that, at a minimum, a simplified yield curve be adopted, something similar to the interest rate structure used by the PBGC. This part of the proposed changes should be delayed to allow for the required reprogramming.

Transition

Three-year transition: The administration's proposal has a three-year transition period, which may not be sufficient time for contribution volatility concerns, especially if the credit balance provision is eliminated. In addition, if the administration's proposal is adopted without modification, financial observers suggest the need for a longer transition to allow financial markets to adapt to a potential shift in pension asset allocations between stocks and bonds. The bond market, in particular, will need more time for issuers to supply pension plans with the long-dated instruments needed to better match assets to liabilities, without driving interest rates down and exacerbating the problem. A longer transition would be less disruptive. Our anti-volatility mechanism (AVM) could also assist in providing a better transition.

Encourage DB Plans

We applaud the administration's proposal for clarifying the age discrimination and whipsaw issues for hybrid plans. However, the administration's proposal also reaffirms its earlier savings account ideas, requires a five-year maintenance rule for DB plans converting to cash balance plans, and doesn't resolve retroactivity concerns for prior conversions. These three concerns could cause the widespread elimination of *all* DB plans by further making it easier to sponsor a defined contribution plan than a DB plan. By continuing to propose changes that undermine the formation and maintenance of traditional DB plans the administration's proposal could seriously harm DB plans, even though DB plans provide vast financial value and benefits to individuals, employers, the markets, and the nation. We suggest that DB plans need equal treatment with 401(k) arrangements.

At one time policy favored DB plans because (1) they were more likely to provide a lifetime income and (2) they cover almost all employees. With lower tax rates for capital gains and stock dividends, the equilibrium for deciding whether to sponsor a DB or DC plan with all its associated coverage requirements and complex rules, versus just providing cash to employees, has been greatly harmed. We recommend that Congress return its historic tax advantage to retirement plans by taxing pension distributions at the same rates.

Summary

The administration proposes many valuable changes. For Congress to strengthen national retirement security, they must provide an environment that encourages employers to keep their DB plans and pay premiums to PBGC. At a minimum, reform should include:

- controlling the volatility of contributions (by, for example, using the anti-volatility mechanism);
- retaining the credit balance concept (with modifications) to reduce the cyclical nature of minimum contributions and provide incentives for employers to make contributions in good years; and
- allowing employers to access super surpluses for other uses, such as other employee benefits, as an incentive for employers to contribute in good years.

At the American Academy of Actuaries, we are dedicated to applying our understanding of DB plans to working with the administration and Congress to shape a strong system of financial security for our nation's retirees.

Chairman CAMP. Thank you very much. Mr. Weller, you have 5 minutes to summarize your testimony, and your written statement will be made a part of the written record as well.

STATEMENT OF CHRISTIAN WELLER, SENIOR ECONOMIST, CENTER FOR AMERICAN PROGRESS

Mr. WELLER. Thank you very much, Chairman Camp, Ranking Member McNulty and Members of the Subcommittee for inviting me here today. Addressing retirement security through sensible pension reform should be guided by the following three goals: maintain the security of the existing benefits, promote and sustain sponsorship of defined benefit (DB) plans, and maintain the ability of the PBGC to insure DB in the future. The Administration recently proposed a set of changes to the existing funding rules. These proposals always tend to link pension funding more to market fluctuations than is currently the case. However, when it comes to pensions, employers are most concerned with unpredictable volatility of their contributions. By increasing the volatility of pension funding, employers would have very strong incentives to terminate their plans and shift the risks on to their employees under the Administration's plan. Importantly, pension funding depends on interest rates and asset prices, which move with the business cycle, as already discussed. This leads to countercyclical funding, requiring greater contributions during bad economic times and fewer contributions when times are good. A plan's funding status depends on how assets compare to liabilities. Liability is a future benefit, discounted to the present using a prescribed interest rate. If the interest rate accurately reflects future interest rates, employers should know exactly how much money they need today to cover, together with interest earnings, future benefit payments that can then contribute this amount, so that assets equal liabilities. The problem arises because interest prices and stock values deviate from the assumed values over time. Specifically, they decline in a recession. From 1927 to 2001, there was only one recession where interest rates did not decline. Also, the stock market peaks about a year before a recession starts and continues to decline in the middle of a recession. It is in the middle of a recession firms typically have higher liabilities and lower than expected assets, and hence have to contribute more than before. The recent recession posed a particular challenge, since stock prices fell sharply and interest rates stayed lower and lower longer than previous recessions. The problem was further exacerbated by the fact that companies have not built up more reserves during the prior expansion. The Administration's proposal would increase the funding volatility.

First, the Administration is proposing to eliminate the 4-year weighted average and to replace it with a single Treasury rate with a yield curve. The applicable rates will be averaged over 90 days instead of the 4 years. Second, the Administration proposes that all assets be valued at fair market value, eliminating the option to smooth on that side. Employers would become more likely to see larger contributions during bad economic times under the Administration's proposal. The smoothing of interest rates is eliminated, which would raise the chance of rising liabilities in a recession.

In addition, the yield curve itself would increase volatility. The spread between short-term and long-term interest rates tends to rise during a recession because short-term interest rates fall faster than long-term interest rates. All employers would thus see their costs rise faster than under the current rules because of the fast decline in short-term interest rates. Employers could respond to this volatility by matching assets and liabilities—by investing solely in bonds called immunization. Immunization would significantly raise the cost of pension plans for sponsors, since it would eliminate the added earnings from investing in stocks, which could lead to more plan terminations.

There are alternative rules that could reduce the volatility of funding pension contributions without jeopardizing the security of pension benefits. In model calculations that I have done with my colleague Dean Baker from the Center for Economic and Policy Research, we have shown that the introduction of more smoothing would reduce the volatility of planned contributions without harming the funding status of pension plans and jeopardizing pension benefits. Specifically, funding rules should be less countercyclical and not more countercyclical. This approach is more consistent with the nature of a pension plan as a going concern. It gives a clearer view of how well a pension plan is prepared for the medium term when it is expected to compare benefits. By comparison the Administration's proposal only provides a snapshot of the pension plan at the time of valuation. It is inaccurate the next day, basically, because things change so quickly.

The alternative that we are putting forward focused on three ways to make funding rules more cyclical. Average interest rates over 20 years assume stock price adjustments over 20 years and require funding to 120 percent of current liabilities. These alternative rules would reduce volatility of pension contribution, especially by lowering required pension contributions during bad economic times, without lowering the average funding status. Employers would win because their contributions are more predictable, and employees would benefit because their benefits are more secure, and the

PBGC would win because the overall funding status would improve. Thank you very much.

[The prepared statement of Mr. Weller follows:]

Statement of Christian Weller, Senior Economist, Center for American Progress

Thank you very much, Chairman Camp and ranking member McNulty, for inviting me here today to testify on proposed rule changes regarding single-employer defined benefit plans.

Retirement income security occupies much of the public policy debate these days. While most of the attention is focused on attempts to privatize Social Security, the security of defined benefit pension plans is also in the balance. Pensions have received a lot of attention recently since falling interest rates and stock prices left DB plans with fewer funds than they need to cover all promised benefits. In extreme cases, pension plans were terminated, leaving workers with substantially fewer benefits than they had expected and resulting in shortfalls at the Pension Benefit Guaranty Corporation (PBGC).

Public policy can address the problems plaguing defined benefit pension plans through sensible reforms. In considering these reforms it is important to keep the following goals in mind:

1. Maintain the security of pension benefits;
2. Promote and sustain sponsorship of defined benefit plans; and
3. Maintain the ability of the PBGC to support DB plans.

The administration recently proposed a set of rule changes for single employer DB plans. Characteristic of the crucial aspects of this proposal is a greater tendency to link pension fund assets and liabilities to the market. Such a move would fail the goals for public policy reform. By increasing the volatility of pension funding, employers would have very strong incentives to terminate their existing pension plans, further lowering retirement income security for workers.

A closer look at pension funding and proposed rule changes shows the following:

- Current funding rules are counter-cyclical. Employers are required to contribute more to pension plans during bad economic times than during good times.
- The administration proposal would exacerbate the counter-cyclicality of pension funding and increase the uncertainty associated with pension plans. Employers would likely terminate their plans instead of absorbing the additional costs associated with attempts to reduce funding volatility by investing solely in bonds.
- Alternative funding rules could provide for greater leeway in averaging fluctuations in pension funding over the course of a business cycle and improve the outlook for pensions. This process is called "smoothing."
- As a result of smoothing, the burden on the PBGC would be reduced through better-funded pension plans. Employers would benefit as pension funding would become less counter-cyclical, lowering the burden during bad economic times and increasing it during good economic times, when employers are best able to contribute to their pension plans.

Plan Sponsorship Linked to Counter-Cyclical Funding Volatility

Changes in the way pensions are regulated will inevitably affect employer behavior. Employers are mainly concerned with unpredictable demands for outlays for their pension plans (Hewitt, 2003) This is typically more important than other issues, such as simplifications to the rules. Changes in funding contributions arise, when the funding status of a plan changes. For instance, a deterioration of a plan's funding status would increase the financial demands on employers in two ways. For one, they would have to make additional contributions to their plans, as is discussed below, and second, they may have to pay higher insurance premiums to the PBGC. Typically, the size of additional contributions can easily dwarf the size of additional insurance premiums. The primary focus should thus be on the determinants of funding contributions. If changes in funding rules lead to more volatility in the funding status of pension plans and thus to increased uncertainty about employers' future obligations to their plans, employers would become more likely to terminate their plans than is currently the case.

In a defined benefit (DB) pension plan, the employee is guaranteed a fixed benefit upon retirement, usually based on years of service, age and either final earnings or a benefit multiplier. Accrued benefits for private sector DB plans are insured, up to certain limits, by the Pension Benefit Guaranty Corporation (PBGC), which is funded by insurance premiums from employers with DB pensions as well as investment income and assets from terminated pension plans.

Although DB pension coverage has declined for some time, millions of employees and their families still depend on this benefit. The share of private sector workers with a DB plan has declined from 39 percent in 1975 to 21 percent in 2004 (PWBA, 1998; BLS, 2004). By 2002, the last year for which data are available, more than 34 million beneficiaries could still expect to receive some benefits from DB pensions (PBGC, 2003).

The funding of a DB plan's liabilities (promised benefits) is usually the employer's responsibility. Up until 2000, many employers could not contribute more to their plans, as their pensions were well funded due to the strong stock market performance and rising interest rates. However, after 2000, pension funds faced large shortfalls and employers sponsoring them had to contribute large amounts to their pension plans. Many large firms with pension plans have faced persistent shortfalls. PBGC (2004) estimated that the combined shortfall of all single-employer DB plans as of September 2004 was $450 billion. Consequently, firms had to contribute new money to their plans. For instance, 90 percent of DB plans offered by companies included in the S&P 500 index showed a loss. When contributions rose, corporate earnings were often adversely affected, although some firms passed the additional costs on to consumers in the form of higher prices (Kristof, 2003). In extreme cases, the demand on employers' resources from the weak economy and pension plan underfunding contributed to corporate bankruptcies and plan terminations. The PBGC took over plans from Bethlehem Steel, LTV Steel, National Steel, TWA, U.S. Airways and Polaroid, among others. All of these terminations were among the ten largest since 1974, totaling $8.5 billion in claims and covering 263,861 participants (PBGC, 2003).

Even though the PBGC insures benefits, it does so only within limits. By statute, PBGC's insurance is capped, currently at $45,600 per year for a retiree at age 65 under the agency's single-employer pension insurance program. This maximum, though, is reduced for early retirement benefits. Other reductions are taken for survivorship and disability benefits and recent benefit improvements. Beneficiaries can also not accrue further benefits after the plan has been terminated. Hence, a plan termination leaves workers with less retirement security than expected.

To discuss the magnitude of recent pension plan shortfalls, it is important to understand the mechanics of pension plan funding. A plan's funding status depends on how assets compare to current liabilities. Current liabilities are the sum of payments to current retirees and of benefits that workers have already earned. In earnings-based plans, future benefits are forecast given reasonable assumptions about life expectancy, inflation and other relevant demographic and economic variables. Based on these forecasts, pension plans determine how much in assets they need to fund benefits payable in the future. Thus, they assume how much interest they expect to earn on their assets. The higher this interest rate is, the fewer assets are needed today. It is in a plan sponsor's interest to assume a high interest rate since this would lower the amount of assets required to be set aside to pay benefits. To avoid abuse, regulators set a range of interest rates that pension plans can choose from in calculating current liability. Pension plans must choose an interest rate that is between 90 percent and 105 percent of the four-year weighted average of the 30-year Treasury bond yield.[1]

A pension plan's funding status is then determined by looking at the ratio of the plan's assets to its liabilities. Plans can choose a number of options to value their assets, although many large plans use fair market valuation. Assets are evaluated at prices for which the assets could be sold on the valuation date.

By the nature of funding rules, pension plan funding is tied to changes in interest rates and stock prices. The main problem is that both of these tend to decline around the time of a recession, when corporate earnings are also declining.[2] From 1927 to 2001, there were a total of 12 recessions. Only in one recession, from 1973 to 1975, did interest rates not decline. The stock market is a forward looking indicator. Typically, the stock market peaks about a year before a recession starts and continues to decline in a recession. On average, stock prices are about 7 percent lower in the year after a business cycle peaks than before. That is, pension plans are losing with their assets before and during a recession, which brings additional

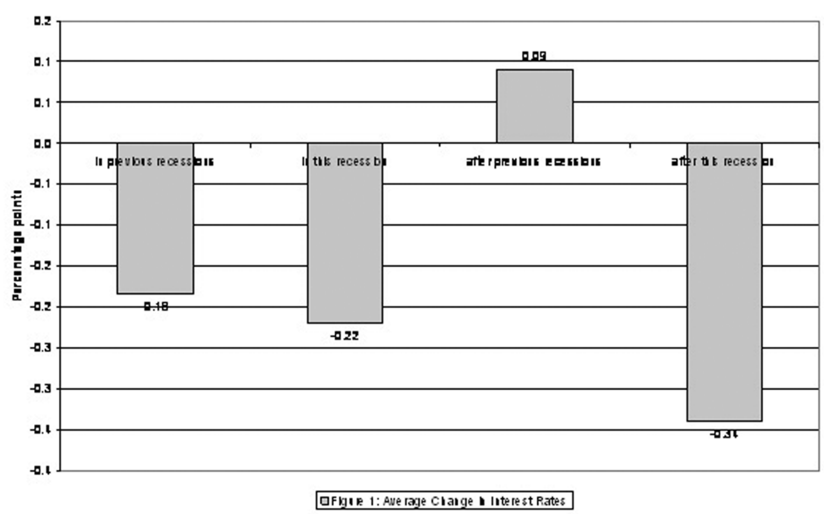
[1] The Pension Funding Equity Act of 2004 required that plan sponsors use a discount rate between 90 percent and 100 percent of a 4-year weighted average of a blend of investment-grade corporate bond yields for plan years beginning after December 31, 2003, and before January 1, 2006.

[2] Interest rates refer to the long-term treasury bond rate and total rates of return refer to the year-on-year change in the stock market plus the dividend yield. Stock market data are for the S&P 500.

pressures due to lower corporate earnings and lower interest rates that translate into a higher valuation of a plan's liabilities.

The recent recession posed a particular challenge since stock prices fell sharply and interest rates stayed lower, and lower longer, than in prior recessions (Weller and Baker, 2005). From the start of the recession in March 2001 to the end of 2002, the stock market fell by 25 percent. From its peak in August of 2000 to its low point in February 2003, the stock market lost 44 percent of its value. At the same time that the stock market sustained severe losses, interest rates declined more and stayed low for a longer period than on average in previous recessions (figure 1). In this recession, the treasury rate declined by 0.22 percentage points, slightly above the average of 0.19 percentage points for prior recessions. However, in the first year of a recovery, interest rates generally rise by 0.10 percentage points, whereas they fell by another 0.34 percentage points in this recovery. Thus, in this recovery employers did not see the usual help in funding their pensions that would come from rising interest rates.

Figure 1: Average Change in Interest Rates



The problem of falling asset prices and declining interest rates in the recent recession was further exacerbated by the fact that companies had not built up more reserves during the prior expansion. This can be traced back to two aspects of the current regulatory system. First, if a pension plan reaches a certain funding threshold, the employer either no longer has to contribute or has to contribute only minimal amounts. Second, there are regulatory disincentives to contribute more to a pension plan when it is already fully funded. If pension plans are fully funded, employers face excise taxes on their contributions to the tune of 50 percent. On top of that, they can no longer deduct their pension contributions from their tax liabilities. The contribution limit beyond which further contributions are discouraged by the tax code is 100 percent of current liabilities. Thus, largely due to beneficial financial market trends—rising interest rates and higher stock prices—the average funding ratio of PBGC insured pension plans jumped from 116 percent in 1999 to 145 percent in 2000 (PBGC, 2003). However, for many plans, this reserve was insufficient to weather the crisis that followed as the stock market bubble burst and the liability discount rate sunk to and remained at historically low levels. In 2002, 74,138 new beneficiaries started receiving payments from PBGC, compared to 40,473 new beneficiaries in 2001 and only 11,091 in 2000 (PBGC, 2003).

Administration Proposal Will Exacerbate Funding Problems

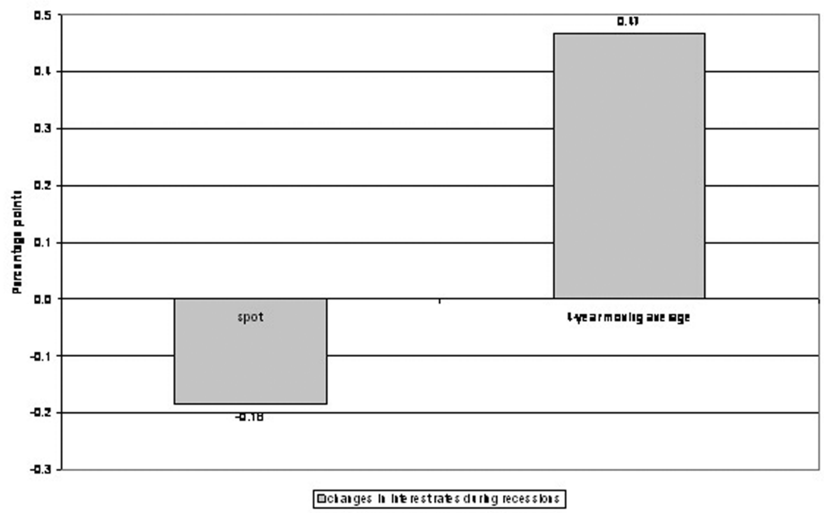
The administration recently released its own proposal to reform funding rules, among other changes to the pension system (DOL, 2005). Funding burdens are already counter-cyclical, requiring employers who sponsor DB plans to contribute more during bad times than during good times. The administration's proposal could exacerbate this volatility in addition to the overall costs of some plans. First, the current rules require the use of a 4-year weighted average of the 30-year Treasury bond rate to determine current liabilities. The administration is proposing to eliminate the 4-year weighted average and to replace the single treasury rate with a range of bond rates, the so-called yield curve. This would mean that liabilities—future benefits—that come due at different future dates are discounted by different interest rates. For example, a benefit that is due in 10 years will be discounted by the interest rate on corporate bonds with 10-year maturity; a benefit that is due in five years will be discounted by the 5-year rate, a benefit in 15 years by the 15-year rate and so on. The applicable rates would be averaged over 90 days, instead of 4 years. Second, the administration proposes that all assets be valued at fair market value, thus eliminating the current option to average stock price fluctuations over short periods of time. If these changes are enacted, plan sponsors worried about the predictability of their future contributions would have strong incentives to abandon their plans.

The administration's proposal would raise the costs of mature plans immediately. Employers who have a disproportionate number of older workers, e.g. in well established industries, will face rising costs from the administration's yield curve proposal. This is because older workers are likely to retire sooner than younger workers and their benefits will have to be paid out sooner than those for younger workers. The discount rate is tied to corporate bonds with shorter maturities. Those interest rates are lower than those for corporate bonds with longer maturities. A lower discount rate translates into a higher liability and higher cost for the employer. According to estimates by the Employment Policy Foundation (2005), the liabilities for workers 55 and older could increase by 3.5 percent and the liabilities for workers between 50 and 54 could rise by 2.0 percent. This would particularly hurt the struggling manufacturing sector. That is, the administration's proposal would fall short of the first goal to secure existing benefits.

In addition to raising the costs for some plans, the administration's proposal on changes to the interest rate would exacerbate cyclical fluctuations, just like the use of fair market value for assets does, as already discussed.[3] Employers would become more likely to see larger contributions during bad economic times, mainly because the smoothing of interest rates over even the minimal period of time of four years is eliminated. From the 1930s to the present, the spot interest rate for long-term Treasury bonds would have declined by an average of 0.18 percentage points during recessions. In comparison, though, the 4-year weighted average of the long-term Treasury bond rate would have risen by 0.47 percentage points. The fact that the discount rate is on average 0.65 percentage points higher with smoothing than without means that employers face fewer demands on their cash flow when they can least afford them. However, it also means that they face higher funding obligations during good years, when they can actually afford them.

[3] Employers could theoretically insulate themselves from these fluctuations by matching assets to liabilities. However, such a "bonds only" strategy would substantially raise the costs for employers to provide this benefit and thus give another strong disincentive to abandon their plans.

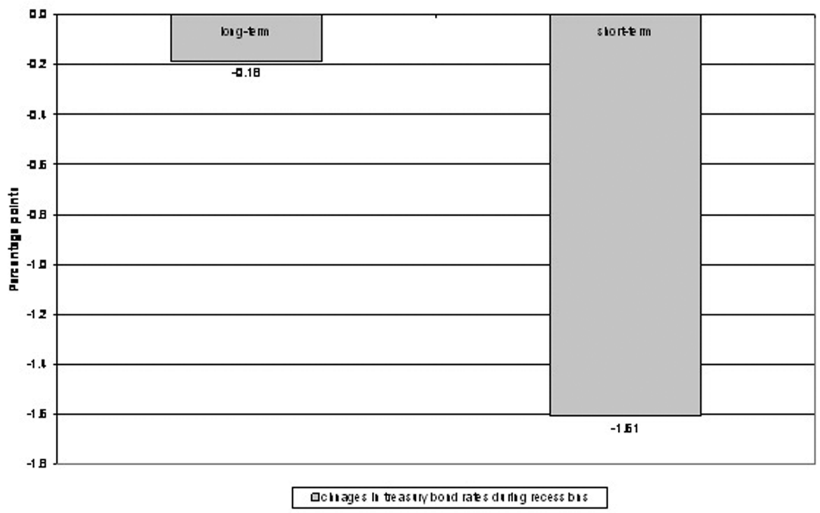
Figure 2: Changes in Interest Rates During Recessions, With and Without Averaging



The use of a yield curve, using a variety of interest rates with different maturities for separate liabilities, would also exacerbate the funding burden during economic downturns, especially for pension plans with a more mature workforce. Specifically, the spread between short-term and long-term interest rates tends to rise during recessions, largely because short-term interest rates tend to fall faster than long-term interest rates. Short-term Treasury interest rates, in this case for 3-month bills and bonds, have typically declined by 1.6 percent during recessions (figure 3). This is an increase that is almost eight times as large as the average decline of long-term Treasury bond rates during recessions. During a recession, employers with an older labor force will see their costs rise much more rapidly than employers with a younger workforce.

The use of a yield curve would increase the volatility of pension contributions for employers, thus providing an incentive to terminate DB plans. That is, the administration's proposal falls short of the second goal to maintain and strengthen future benefit security.

Figure 3: Changes in Long-Term vs. Short-Term Treasury Bond Rates During Recessions



Immunization Not a Viable Alternative

Fluctuations in liabilities and assets can lead to changes in the funding status of pension plans. When interest rates and asset prices fall, plans can become underfunded. The administration's proposal would increase the volatility of the future funding status of a DB plan. Employers could theoretically respond to this surge in volatility by matching assets and liabilities by investing in bonds that reflect the maturity of a pension plan's liabilities. This process is also referred to as immunization.

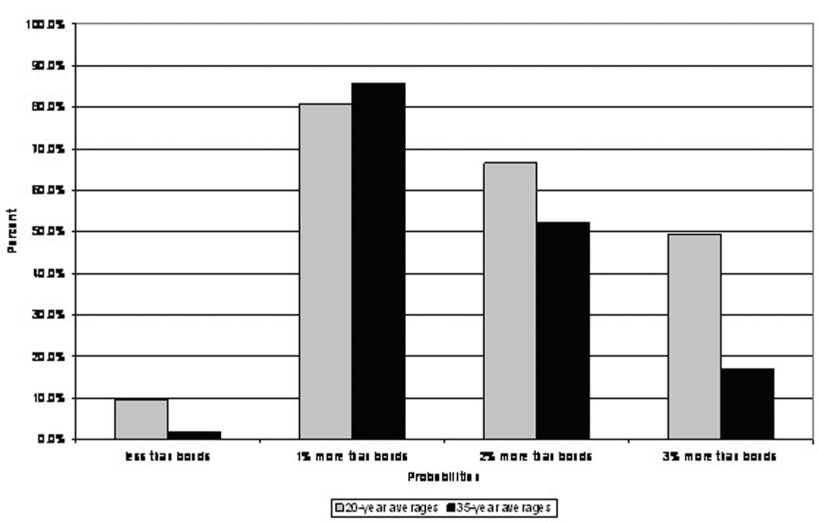
To understand how immunization works, consider the way a pension plan's liabilities would be calculated under the administration's proposal. Future benefit payments would be discounted by the interest rates that would apply for treasury bonds with the same maturity as the benefit obligation. To finance new obligations, pension plans have to purchase additional assets. To avoid fluctuations in funding status under the administration's proposal, pension plans could purchase a corporate bond with the same maturity and thus the same interest rate as the maturity of the benefit obligations (Bodie, 2005). As a result, assets would theoretically be matched to the liabilities and the two could not move apart over time. Underfunding would thus be reduced.[4]

Although the logic of immunization is appealing, it has one major drawback, aside from the potential complexity of implementation, that would ultimately hurt pension beneficiaries substantially. Immunization would significantly raise the costs of pension plans for plan sponsors. Typically plans diversify their assets between different types of securities, largely bonds and stocks. By doing so, plans can expect to earn a higher rate of return over the long-run than they could by merely investing in bonds, while reducing the risks. Through immunization, plans would eliminate the added earnings from investing in stocks. This loss can be severe. Over 20-year or even 35-year periods, the chance of a typical mixed portfolio of a pension plan—60 percent stocks and 40 percent bonds—is unlikely to perform worse than bonds. The chance that a mixed portfolio will on average see a rate of return that is a least one percentage point higher than a pure corporate bond allocation is more than 80 percent (figure 4). The chance of seeing a rate of return that is at least three percentage points greater is 50 percent over 20-year periods and 17 percent over 35-year periods. These are the potential earnings that pension plans would give up through immunization. This loss of earnings would require an offset from higher

[4] Perfect matching would likely not be possible since the administration's proposal allows for discount rates to be smoothed over 90 days.

employer contributions to their pension plans.[5] As costs of pension plans would rise, employers would have again a strong incentive to abandon their plans.

Figure 4: Performance of Mixed Portfolios over 20 and 35 Year Periods



Notes: Data are based on S&P 500 and corporate bonds (AAA) from 1919 to 2004. Sources are TradeTools.com, Shiller (2000), and BOG (2005).

However, if pension plans do not immunize, they can face market fluctuations from investing in stocks. Uncharacteristically large fluctuations in the stock market substantially contributed to the decline in pension funding after 2000. This leads to two questions. First, who should bear this risk, and second, is there another way to handle the risk exposure of pension plans, which does not increase the volatility of pension plan funding for employers and thus does not raise the specter of plan terminations? The answer to the first question is that pension plans are better equipped than individuals to handle market risks. The answer to the second question is detailed in the next section.

Pension plans are better equipped than individuals to handle the risks associated with investing for retirement. However, if funding rule changes provide employers with strong incentives to terminate their DB plans, individuals would have to increase their efforts to save for retirement through private accounts, such as 401(k)s or IRAs, to maintain the same level of retirement income. Even if individuals invest prudently, they still face large market fluctuations. Some workers would thus retire with substantially less retirement income than they were counting on, while others would do better than expected, depending on how well the market did during their lifetime (Weller, 2005). The problem is that individuals can often not wait for the market to improve again since many of the reasons for retirement, such as deteriorating health, will likely get worse with age. In contrast, pension plans are going concerns that can expect additional income as they pay out benefits for the foreseeable future. Because pension plans generally do not have to liquidate their assets on a given date, they can, at least to some degree, wait for markets to improve. After all, this is the logic behind using an average interest rate to calculate pension plan liabilities. Thus, pension plans are much better equipped than individuals to withstand the risks associated with investing in stocks.

As a result of the administration's proposal, pension plans would be faced with an unappealing choice. They would either face increased volatility in their pension contributions or the costs of funding their pension plans would rise substantially. In either case, employers would have strong incentives to reduce their commitments to their employees through their DB pension plans and shift the risks of saving for

[5] Mixed portfolios will not always do better than pure bond portfolios. There is a chance that stock market fluctuations are large and it takes long periods of time for stocks to recover those losses (Weller, 2005).

retirement onto their employees. While pension plans are better equipped than individuals to handle long-term fluctuations in the stock market, the question still remains whether there are alternative funding rules that could help to reduce the volatility of pension contributions for employers and lower the incentives to terminate pension plans, without jeopardizing the security of pension benefits now and in the future. The answer is yes and the details are provided in the next section.

More Smoothing Improves Benefit Security

The problem as described above is that, under current funding rules, employers are more likely to have to make contributions to their pension plans when times are bad. When times are bad, more employers are unable to make payments to their pension plans. Therefore, pension terminations spike and the burden on the PBGC grows. The rules proposed by the administration would exacerbate this problem, while also raising the costs for employers with an older workforce. However, it is possible to change the funding rules, so that benefits are protected, employers have more certainty associated with the funding of their pension plans, and the PBGC will end up with fewer terminations.

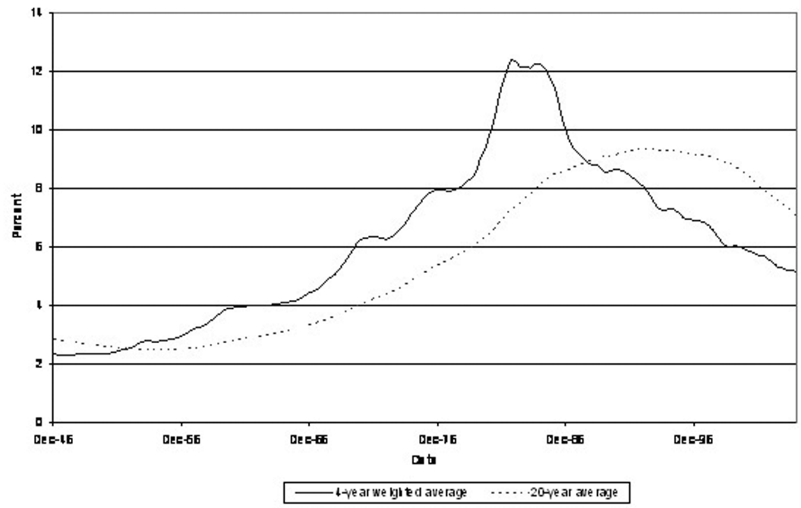
The basic premise underlying these funding rules is that they should be more procyclical, allowing employers to contribute more during good times and contribute less during bad times, when they can least afford it.

Such an approach is also more consistent with the nature of a pension plan than the administration's approach. The proposals laid out here give a clearer summary view of how well a pension plan is prepared for mastering the challenges of the medium-term future, when it is expected to pay benefits. By comparison, the administration's proposal to move towards a process of "marking to market" provides only a snapshot of the pension plan at the time of valuation. This is a consistent and accurate view only if it is assumed that the pension plan will terminate shortly after valuation. Under all other circumstances, the assumptions are too volatile to provide an accurate glimpse of the plan's future.

Three funding rule changes seem especially relevant. First, one way to reduce the cyclicality of pension funding is to use a long-term average of the benchmark interest rate, e.g. a 20-year average. This would substantially reduce the volatility of calculating pension fund liabilities and it would de-couple funding requirements from the fluctuations of the business cycle, since the period over which the interest rate is averaged is longer than any business cycle. A 20-year period is also a much closer match to the average duration of pension plan liabilities. Moreover, because interest rates have recently been so low, the longer-term average would be higher than even the 4-year weighted average. Thus, switching to a longer-term average could give plan sponsors some funding relief in the immediate future, while also improving funding certainty over the long term.[6]

[6] One of the reasons for changing pension funding rules is that the 30-year treasury bond rate is no longer an appropriate bench mark because the treasury has stopped issuing these bonds. It appears reasonable to use the 10-year Treasury bond rate instead. The benchmark rate is supposed to be risk free and reflect the long-term nature of pension liabilities. Both the 10-year and the 30-year treasury bond reflect the most secure assets. The 10-year treasury bond yield reflects the long-term nature of pension liabilities. The federal government will have outstanding debt that is likely to grow. Its financing instrument with the longest maturity is the 10-year Treasury bond. Thus, its yield reflects the long-term nature of the federal debt. Further, data on the 10-year Treasury bond rates are available since 1953—longer than for the 30-year treasury, which was introduced in 1977.

Figure 5: Interest Rate Averages



Second, to mirror the rule change for liabilities, one can also use a 20-year smoothing for stock prices (Weller and Baker, 2005).[7] This process essentially assumes that stocks will adjust towards a long-run average over a long enough period of time. If stock prices are above long-term averages with respect to corporate earnings, they are discounted with the assumption that the adjustment process will take 20 years. The same holds when stocks are too low.

Last, one of the problems associated with the recent funding crisis was that pension plans had not built up enough reserves to weather the storm that ensued after 2000. The administration has recognized this problem and has proposed that employers would be permitted to contribute to their plans even after they meet the full funding target. However, many employers already could have contributed more to their pension plans if they had wanted to during the 1990s (Ghilarducci and Sun, 2005). Hence, the lack of a cushion was to some degree the unwillingness of employers to increase the funding status of their plans, even when times were good. Therefore, a proposal to require companies to fund up to 120 percent of liabilities over a period of 30 years seems reasonable.[8]

The effects of these rule changes on a hypothetical plan can be simulated.[9] To evaluate their effect, though, two questions should be asked. First, does the contribution pattern become less cyclical? Second, does the funding status of a plan weaken because of the rule changes? The changes in the funding status are evaluated using the ratio of assets at fair market value to current liabilities at the 4-year weighted average of the long-term Treasury rate. In addition, the probability of falling below a funding status of 75 percent is calculated.

The alternative rules would have maintained or reduced the burden on plan sponsors compared to the baseline (table 1). That is, on average, employers would have had to contribute less, especially during bad economic times. Using a smoother discount rate would have resulted in contribution holidays from 1998 to 2002 (model (2)); the alternative asset valuation method would have resulted in a contribution holiday after 1999 until 2002 (model (3)); and the requirement of contributions up to 120 percent of current liabilities would have meant no contribution holiday during this five-year period, but contributions would have been equal or less compared to the baseline model (model (4)). When all three changes are in place, the fund

[7] At the same time that more smoothing is allowed, the current practice of credit balances is eliminated.

[8] The baseline assumes normal cost contributions up to 100 percent.

[9] The technical details of the simulation from Weller and Baker (2005) can be found in the appendix.

would have enjoyed contribution holidays for all five years (model (5)), reflecting the build-up of sufficient reserves during the preceding good years.[10]

To see this, the long-term performance of the alternative funding rules is tested, using the past fifty years as an example (table 2). From 1952 to 2002, average contributions would have been approximately the same under all scenarios, or sometimes a little bit less than under the baseline.

However, plans would have built up more reserves due to the funding rule changes. In each case, the CL funding ratio would have been higher than under the baseline scenario. That is, evaluated at current rules, the security of pensions would have improved. Also, in almost all cases, the chance of the funding ratio falling below 75 percent is reduced compared to the baseline (table 2). This again highlights the improved security of pension benefits under the new set of benefits.

To test whether the proposed rules would make pension funding less counter-cyclical, contributions during recessions and non-recessions are considered. From 1952 to 2002, only the alternative asset assumptions would have lowered the contributions during the recessions compared to the baseline model. But for the period from 1980 to 2002, all models would have lowered contributions during recessions. Thus, during the past two decades, employers would have enjoyed more predictability in the funding of their pension plans.

Table 1
Funding Status of Model Pension Plan with Different Funding Rules

	Baseline model		Model (2)		Model (3)		Model (4)		Model (5)	
Discount rate for liabilities	4-year weighted average of long-term Treasury bond yield		20-year average of long-term Treasury bond yield		4-year weighted average of long-term Treasury bond yield		4-year weighted average of long-term Treasury bond yield		20-year average of long-term Treasury bond yield	
Asset assumptions	Fair market value		Fair market value		Adjustments for level and ROR on stocks, and long-term average interest rate for bonds		Fair market value		Adjustments for level and ROR on stocks, and long-term average interest rate for bonds	
Contribution limit	100 percent		100 percent		100 percent		120 percent		120 percent	
	Contribution as share of salary	CL funding ratio	Contribution as share of salary	CL funding ratio	Contribution as share of salary	CL funding ratio	Contribution as share of salary	CL funding ratio	Contribution as share of salary	CL funding ratio
1998	0.0	100.7	0.0	119.7	8.3	137.1	3.3	97.7	0.0	243.1
1999	4.8	98.2	0.0	117.6	6.7	142.2	3.1	97.8	0.0	253.5
2000	0.0	101.9	0.0	118.7	0.0	149.7	2.2	100.1	0.0	255.2
2001	3.6	87.6	0.0	102.7	0.0	131.0	3.6	87.5	0.0	220.6
2002	6.0	76.4	0.0	87.6	0.0	113.2	6.0	76.3	0.0	188.3

Notes: All figures are in percent. Source is Weller and Baker (2005).

[10] The easing of the funding burden during the five years from 1998 to 2002 was a result of substantial build-ups in reserves and thus did not reduce the funding adequacy and the security of benefits. The current liability (CL) funding ratio would have been higher in each case than under the baseline (table 1).

Table 2
Summary Measures for Different Funding Rules, 1952 to 2002

	Baseline model			Model (2)			Model (3)			Model (4)			Model (5)		
Discount rate for liabilities	4-year weighted average of long-term treasury bond yield			20-year average of long-term treasury bond yield			4-year weighted average of long-term treasury bond yield			4-year average of long-term treasury bond yield			20-year weighted average of long-term treasury bond yield		
Asset assumptions	Fair market value			Fair market value			Adjustments for level and ROR on stocks, and long-term average interest rate for bonds			Fair market value			Adjustments for level and ROR on stocks, and long-term average interest rate for bonds		
Contribution limit	100 percent			100 percent			100 percent			120 percent			120 percent		
	Avg. cont. to salary	Avg. fund. Ratio	Prob. of less than 75%	Avg. cont. to salary	Avg. fund. Ratio	Prob. of less than 75%	Avg. cont. to salary	Avg. fund. Ratio	Prob. of less than 75%	Avg. cont. to salary	Avg. fund. Ratio	Prob. of less than 75%	Avg. cont. to salary	Avg. fund. Ratio	Prob. of less than 75%
1952–2002	2.6	98.6	4.1	2.0	116.6	3.4	2.7	101.1	0.7	2.4	109.1	3.0	2.5	137.2	7.7
	(2.7)	(13.6)		(2.7)	(28.1)		(3.0)	(13.9)		(1.5)	(18.1)		(3.4)	(38.7)	
1980–2002	3.0	100.3	9.5	0.0	144.4	1.6	2.8	102.6	0.1	1.7	115.4	4.6	0.0	176.2	0.0
	(3.5)	(19.3)		(0.0)	(16.9)		(3.4)	(18.7)		(1.6)	(23.9)		(0.0)	(14.5)	

Notes: All figures are in percent. Figures in parentheses are standard deviations.

Table 3
Contributions during Recessions and Non-Recessions

	Baseline model		Model (2)		Model (3)		Model (4)		Model (5)	
	Recession	Non-recession	Recession	Non-recession	Recession	Non-recession	Recession	Non-recession	Recession	Non-recession
1952–2002	2.2	2.8	2.5	1.8	1.7	3.2	2.6	2.2	3.4	1.8
1980–2002	2.0	3.4	0.0	0.0	0.7	3.8	1.8	1.6	0.0	0.0

Note: All figures are in percent.

There are clear benefits from implementing more smoothing in pension funding rules. Employers would gain predictability in the funding of their pension plans, while the funding status of pension plans would generally improve. Thus, employees would enjoy greater security of their benefits and the PBGC would ultimately see a reduction in the probability of plan terminations.

This proposal would also introduce funding rules that are more consistent with the going concern nature of pension plans. Using long-term averages assumes that pension funds will buy and sell securities, and that these transactions will occur at different interest rates. The time frames over which the smoothing occurs are generally consistent with the typical duration of pension liabilities. The proposals laid out here give a clearer summary view of how well a pension plan is prepared for mastering the challenges of the medium-term future, when it is expected to pay benefits.

Numerous proposals, including the administration's, have recognized the benefits and the consistency of smoothing in funding rules for the future well-being of pension plans. However, such proposals allow for more smoothing on the plan contribution side, rather than on the asset and liability valuation side (DOL, 2005; Towers Perrin, 2005). This still leaves the problem that "marking to market" does not provide an accurate view of how well the plan is prepared for the future. Furthermore, even those who propose more smoothing of contributions don't necessarily believe that it will actually work. When introducing the administration's plan, Secretary of Labor Elaine Chao was quoted as saying in the New York Times on January 30, 2005, that workers will "pressure their employer to more adequately fund the underfunded pension plans." Secretary Chao's comments indicate that the administration is counting on the large volatility of pension funding that would result from its new funding rules to scare workers into demanding more pension contributions from their employers. That is, regardless of the funding rules, employers may be forced to increase pension contributions to stave off employee dissatisfaction. However, this may only be a short-term phenomenon. Because the funding status of a pension plan would become more volatile, the contribution demands from employees at one point in time may become quickly obsolete as asset prices and interest rates change. The result would be frustration on the part of employees and large short-term pressures on employers, with the likely result that more and more employers would abandon their pension plans. Instead, the proposal laid out here would provide employees with a more accurate picture of the long-term health of their pension plans and stabilize the contribution stream of employers to their pension plans.

Conclusion

After 2000, defined benefit pension plans experienced severe underfunding. While the magnitude of the problem was unprecedented, the combination of the underlying factors was not. Employers should expect a regular recurrence of declining interest rates and asset prices during a recession. Current funding rules reflect this regularity and the administration's proposal to change these funding rules will not make the problem better, but exacerbate the counter-cyclical volatility of pension funding. Thus, the administration's proposal falls short of the standards laid out in the introduction. It would reduce the chance that future benefits will be maintained and it could jeopardize the pension security in well established pension plans through higher costs.

Instead of increasing the volatility of pension funding, which would drive more employers to terminate their pension plans, there are rule changes that would allow for more smoothing of pension liabilities and assets and thus stabilize pension funding. Empirical results show that this would result in more stable employer contributions to pension plans and to higher average funding ratios. Employers would benefit from greater certainty about the future of their pension plans, while employees and the PBGC would benefit from greater security of pension benefits. Thus, these alternatives would meet all three goals of sensible funding rule changes. They would secure existing benefits, help to maintain benefit security in the future, without unduly burdening the PBGC.

Thank you very much for this opportunity to present my views on pension funding rules. I am looking forward to your questions.

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Appendix: Technical Details of Pension Model

The basic simulation model referenced here is developed in Weller and Baker (2005).

Asset valuation method

First, the difference between market price and trend price is calculated for the current period:

$$\left(\frac{Pt}{\overline{\overline{Pt}}}\right) = \frac{Pt}{\overline{\overline{Et}}(\overline{\overline{P/E}})} = \frac{Pt}{\overline{\overline{Et}} - 1(1 + \breve{E})(\overline{\overline{P/E}})} \qquad (1)$$

where P is the current market price as measured by the S&P 500 index and $\overline{P}$ is the trend price. The trend price is equal to the trend earnings, $\overline{E}$, times the long-term average price to earnings ratio, $(\overline{P/E})$, since 1927 of 15.3. Further, the trend earnings in period t are equal to the trend earnings in the previous period after having grown at the long-term average earnings growth rate, $\breve{E}$, *of 5.0 percent*.

Next, it is assumed that the difference between market price and trend price disappears over a period of 20 years, which generates an adjustment factor, AF, to the market price of stocks of:

$$AFt = \left(\frac{1}{1 - rt}\right) \qquad (2)$$

where the adjustment rate, r, is defined as:

$$rt = \ln\left(\frac{\overline{P}t}{Pt}\right) / 20 * 100 \qquad (2')$$

such that the adjusted price, P*, is described by:

$$P*t = PtAFt \qquad (2'')$$

Since the expected rate of return to stocks is the sum of the rate of capital appreciation and the dividend yield—dividends relative to market price—the adjustment made to the price also affects the expected dividend yield, such that the adjusted dividend yield is equal to the ratio of dividends, D, to the adjusted market price, P*.

We also assume that the difference between the actuarial value and fair market value disappears after 20 years, and that assets other than stocks earn the same long-term interest rate as for liabilities plus 50 basis points.

Basic pension plan design

The number of workers is assumed to have been 10,000 in 1952, equally distributed from age 20 to 65, with 80 percent of workers blue collar and 20 percent white collar, labor force growth equal to 1 percent annually, and annual wage growth equal to 3 percent. Assumed attrition is 5 percent, equally distributed, and the number of vested workers is proportional to that of job leavers. We use the age earnings profile for blue- and white-collar workers from Engen et al. (1999).

Retirement benefits are based on average final pay, with retirement benefits equaling 1 percent of the average of the last five years of earnings for each year of service, with five years of vesting, and no ancillary benefits. Current liabilities are then calculated using the unit credit method. Assets are held in stocks and bonds. From 1952 to 2002, the pension plan's asset allocation into equities is equal to the share of directly held corporate equities out of assets for all pension plans (BoG, 2003). The rate of return earned on stocks is set equal to the increase in the S&P 500 plus the dividend yield, and the rate of return on bonds is equal to the treasury rate plus 50 basis points.

Chairman CAMP. Thank you very much. Mr. Eickelberg, you have 5 minutes, and your written statement will be part of the record.

STATEMENT OF HENRY C. EICKELBERG, STAFF VICE PRESIDENT, HUMAN CAPITAL PROCESSES, GENERAL DYNAMICS CORPORATION

Mr. EICKELBERG. Thank you, Mr. Chairman, Ranking Minority Member McNulty, distinguished Committee Members. I am here representing, I guess, business—representing American Benefits Council, American Council of Life Insurers, Business Roundtable, ERISA Industry Committee (ERIC), National Association of Manufacturers, and the U.S. Chamber of Commerce. Two months ago when they announced this bill, I was 50 pounds lighter and had a full head of hair. In all seriousness, I am worried about what is going to happen to our plans—I am worried about this little town called Pensionville. Pensionville is an old community. It has been around a long time, and it has raised a lot of families. Over the years, people have begun to move out. Pensionville hasn't been such a friendly place lately. It is run by an organization called Potters Bank and Guaranty Corporation, short for PBGC. Over the years the PBGC has found itself having to take over houses in Pensionville, and it is not very happy about having to do that. Mr. Potter, who is the president of the PBGC, has asked the local community to pass some ordinances which, in his words, are designed to save the neighborhood, increasing strength in the financial integrity of the neighborhood. This isn't the first time that Mr. Potter has been asking the local community to pass ordinances. Over the years, the population of Pensionville has dropped from 62,000 people down to 32,000 people. His first ordinance is he wants to increase the real estate taxes from $19 per 1,000 to $30 per 1,000. He also wants to do a special assessment. If your house value falls too quickly, he wants you to shore that up financially. His second proposal is if you are interested in moving into Pensionville, you don't live there right now, if you want to build in Pensionville, you have got to pay cash for your house. You can't start up a new—you can't buy a house and get a mortgage in Pensionville. A brandnew house, we have to pay cash. The other thing that he wants to do to shore up the integrity and encourage people to move into Pensionville, and he wants people who live there and have a loan outstanding, well, he wants them to pay it off. If they are a little short, he will give them up to 7 years. Now, if you don't have good credit and you live in Pensionville, well, the rules are a little different, and in that case, most of the time, if you don't have good credit you find yourself having to move out of Pensionville. He has to take back your house, and he has to sell it at a fire sale. So, he recognizes the fact that it is going to cost him more, so he wants you to pay more than the assessed value in order to make sure that if he asks to take it back he has got enough money to cover it. His other proposal is he wants to close an account. At his bank he used to have an account called the credit balance account. What you would do, if you were a homeowner and you had a little extra cash and it was above your mortgage payment, say you owe $200 in your mortgage, you could put $220 in there and he would take $200 out and pay your mortgage, and the other $20, if you were a little short, you could use to offset your next mortgage payment. He wants to wipe that out. So, it is not a good thing. Too many people abused that. They put that money in there, and, by golly, they want to use it. It is not a good thing.

If you are not interested in living in Pensionville, you can move down the street and live in an apartment, it is called the D.C. apartments, the fine contribution apartments. There all you owe is your rate. You don't have any mess. You don't have to worry about the building. All you have to do is make your monthly payment, and you are done. The problem is: people who lived in Pensionville actually got some value out of their house. The people who lived in DCville, they have to save for their retirement. There is not money for them to do that. I guess the question is, would you live there? Would you encourage your kids to live there? This bill will cost American workers 300,000 jobs. If you are comfortable with that, I suggest you vote for it.

[The prepared statement of Mr. Eickelberg follows:]

Statement of Henry C. Eickelberg, Staff Vice President, Human Capital Processes, General Dynamics Corporation, Fairfax, Virginia

Chairman Camp, Ranking Member McNulty, I thank you for the opportunity to appear before you today on this critically important topic. I am Henry Eickelberg, Staff Vice President for Human Capital Processes for the General Dynamics Corporation, which is a major defense and aerospace company employing over 65,000 people within the United States. In addition to managing General Dynamics' U.S. payroll function and health and safety initiatives, I oversee the design and administration of all of General Dynamics' benefit programs, including its defined benefit pension plans.

Today, I am serving as a spokesman for the American Benefits Council, Business Roundtable, the ERISA Industry Committee, the National Association of Manufacturers, and the U.S. Chamber of Commerce. These organizations represent a broad cross-section of American business. We come before you today with a single voice to emphasize the need to advance our nation's voluntary, employer-sponsored defined benefit pension system.

In recent years, the myth has developed that defined benefit pension plans are dinosaurs—lumbering giants headed to extinction. Nothing could be further from the truth. Defined benefit plans are a core element of how most large and many smaller U.S. employers provide retirement security to their workers. Across the country, some 34 million Americans rely on single-employer, private-sector defined benefit pension plans as a critical element of their retirement security. More than 18 million of these Americans are active workers from a diverse range of industries.

Employees value defined benefit plans because of their unique features. Pension benefits do not typically depend upon employees making their own contributions to the plan, but are instead funded by the employer. In addition, employers, rather than employees, bear the investment risk of funding benefits, and investment professionals manage the assets of the plans. Further, benefits are guaranteed within certain limits through the Pension Benefit Guaranty Corporation (the "PBGC"). Benefits are also offered in the form of a life annuity assuring that participants and their spouses will not outlive their retirement income.

Employers also value defined benefit plans. Sponsorship of a pension plan is a way of rewarding employees' service by providing meaningful retirement benefits, thereby increasing morale, productivity, and the quality of the work environment. With a valued pension plan, employees can focus on today, knowing that tomorrow will bring employer-provided, PBGC-insured retirement income no matter how much they are able to save on their own.

In addition, defined benefit plans play a critical role in our national retirement income system. Single-employer defined benefit plans paid benefits in excess of $120 billion during 1999 (the most recent year for which official Department of Labor statistics have been published). In the absence of defined benefit pensions, it is certain that fewer Americans would be financially prepared for retirement, more American seniors would live in poverty, and many more Americans would be forced to rely even more heavily on already strained federal entitlement programs. These plans also aid our national economy by providing a ready source of professionally managed investment capital with nearly $2 trillion held by private-sector defined benefit plans.

In spite of the value defined benefit plans provide to employees, employers, our national retirement income system, and the U.S. economy, employers have been exiting the defined benefit system in alarming numbers in recent years. Just since 2001, 23 percent of Fortune 1000 companies announced their decision to either freeze or actively consider freezing their defined benefit pension plans. The primary culprits are volatile and unpredictable funding obligations, expensive and excessive regulation, temporary rules, unnecessary barriers to pre-funding, and legal uncertainty regarding the status of cash balance and other hybrid plans.

Reforms are needed to address these issues and ensure that we continue to have a vital defined benefit system well into the future. That reforms can succeed in supporting and expanding the defined benefit system is clear. Since the Economic Growth and Tax Reconciliation Relief Act of 2001 ("EGTRRA") removed some of the restrictions on benefits that can be provided, defined benefit plan coverage among small employers has grown. Among larger employers, cash balance and other hybrid plan designs hold the promise that defined benefit plans will continue to play a critical role in retirement security. More than 7 million Americans are already covered by hybrid plans and this number would be much greater but for the legal uncertainty surrounding these plans.

Targeted reforms are also needed to address the reported deficits at the PBGC. The PBGC plays an important role in the system. However, we must not lose sight of the fact that the vast majority of plans are funded responsibly and appropriately. The PBGC was set up to strengthen retirement security and reforms to strengthen the PBGC should not weaken the rest of the defined benefit pension system. At the end of the day, the success of any reforms will depend on Congress' ability to find the right balance between protecting the PBGC and encouraging a vibrant voluntary employer-sponsored defined benefit plan system.

A few weeks ago, the Administration released its funding and PBGC premium proposals. The proposals would scrap all of the existing funding rules and create an entirely new funding system. The proposals have some elements that we believe would be good for the system. For example, we agree that better disclosure to plan participants is needed. Similarly, we support proposals to change the tax rules to permit employers to contribute more to their plans when they have the ability to do so. In addition, we think that safeguards should be considered to protect the PBGC from benefit increases that are unlikely to be appropriately funded.

At the same time, the Administration's proposals have a number of elements that we believe are counter-productive and would reduce workers' retirement security in the future. Our primary concerns are that the proposals would (1) make funding and premium obligations unpredictable; (2) result in unnecessary bankruptcies; (3) involve an inappropriate use of the credit rating agencies; (4) discourage employers from funding more than the minimum; and (5) drive many employers from the system through considerable and unnecessary PBGC premium increases. These additional barriers and added risks and burdens will only force employers to exit the system through plan freezes and terminations and will discourage other employers from establishing defined benefit plans.

The remainder of this testimony describes the reforms that we believe should be enacted and highlights our primary concerns with the Administration's pension reform proposals.

Tpop 10 Defined Benefit Plan Reforms

1. *Permanently Replacing the Obsolete 30-Year Treasury Bond Rate*. Pension policy must provide employers with the certainty that will allow them to make new capital investments, to hire new employees, and to make R&D investments. A permanent replacement for the obsolete 30-year Treasury bond rate used for pension calculations is needed now.

2. *Making Pension Funding Predictable*. It is essential that any reforms reflect the long-term nature of pension promises and smooth liability and asset valuations. Volatility in these calculations makes it impossible for employers to plan and make prudent business decisions, slowing the economy.

3. *Avoiding Unnecessary Complexity*. The Administration's yield curve proposal would add significant complexity to the system without any real benefit. The long-term corporate bond rate that Congress adopted last year on an interim basis is a simple, appropriate, and transparent measure of liability and should be made permanent.

4. *Preventing Unnecessary Bankruptcies*. Pension reform should not make it more difficult for struggling companies to recover. We must not lose sight of the fact that the best insurance for plans, participants, and the PBGC is a healthy plan sponsor.

5. *Eliminating Prefunding Barriers*. Barriers that prevent employers from making contributions to their plans should be eliminated. We strongly support proposals to revise the tax deduction rules that prevent employers from contributing to defined benefit plans during good economic times.

6. *Encouraging Advance Funding*. The pension system should encourage employers to make contributions to their plans as early as possible. Reform should ensure that there is no disincentive to funding plans in advance of future liabilities.

7. *Providing Timely and Appropriate Disclosure*. Participants should have the information they need to evaluate their retirement security. Existing funding disclosure requirements should be enhanced to provide timely and useful information about retirement plans, while at the same time avoiding the creation of costly, confusing or misleading new requirements.

8. *Funding the PBGC Appropriately*. The best way to protect the PBGC is to keep employers in the defined benefit plan system. Rising and uncertain premiums would force many plan sponsors to exit the system.

9. *Confirming the Legality of Hybrid Plan Designs*. To compete effectively and attract and keep skilled workers, employers must be able to tailor pension plans to the unique needs of their workers and the competitive environment in which they function. The flexibility to utilize varied pension plan designs, including cash balance and other hybrid plans, is imperative if we are to maintain a vital defined benefit system.

10. *Making the EGTRRA Improvements Permanent*. The EGTRRA improvements have led to increased defined benefit plan coverage among small employers and need to be made permanent.

Permanently replacing the obsolete 30-year Treasury bond rate

Since last year, a long-term corporate bond rate averaged over four years has been used on an interim basis to determine "current liability" for the funding and deduction rules and to determine unfunded vested benefits for purposes of PBGC variable rate premiums. However, the measurement rate defaults to the rate on the now defunct 30-year Treasury bond beginning in 2006 if no further action is taken. It is widely agreed that the 30-year Treasury bond is no longer a realistic measure of future liabilities and would inappropriately inflate pension contributions and PBGC variable rate premiums. A return to an inappropriate and inaccurate measure of pension liabilities and the resulting inflated contributions caused by the defunct 30-year Treasury bond rate would be devastating for the ongoing vitality of defined benefit plans and would be enormously disruptive for plan sponsors, and could curtail the strength of economic growth.

We believe the best way to support and enable the defined benefit pension system is to make permanent the four-year weighted average of the long-term corporate bond rate that Congress adopted last year. As Congress has recognized, the long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. It reflects a very conservative estimate of the rate of return a plan can be expected to earn and thus is an economically sound and realistic discount rate.

The Administration has proposed, as an alternative to both the 30-year Treasury bond rate and the long-term corporate bond rate, a near-spot rate "yield curve" comprised of conservative, high-quality corporate bonds. We agree with the Administration that there is a compelling need for a permanent interest rate so that employers can project their future contribution obligations and make long-term business plans. In addition, we agree that the permanent interest rate should be based on high-quality corporate bonds. However, we have concerns about four aspects of the Administration's "yield curve" proposal. First, the yield curve interest rate is a "near-spot rate" rather than a four-year weighted average rate. It will saddle employers with unpredictable funding obligations. Second, the yield curve proposal would apply different interest rates to different payments to be made by the plan based on the date on which that payment is expected to be made. This is an unnecessarily complex methodology. Third, we are concerned that the Administration's mechanisms for creating interest rate assumptions would require excessive and unnecessary contributions for some mature plans, which could be very harmful for employers, workers, and the economy. Fourth, the proposed yield curve is opaque and will be difficult for businesses to use in long-term planning and for Congress to oversee. We discuss these concerns in more detail below.

Preventing the volatility that would be created by spot valuations

Our primary concern with the Administration's yield curve proposal is the use of spot valuations. Companies need to be able to make business plans based on cash flow and liability projections. Volatility in pension costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these contribution obligations be predictable. The essential elements facilitating predictability under current law are use of the four-year weighted average of interest rates andthe ability to smooth out fluctuations in asset values over a short period of time (subject to clear, longstanding regulatory limitations on such smoothing). The Administration's yield curve proposal would, however, eliminate both smoothing elements dramatically increasing the volatility and unpredictability of the funding rules.

Let us be clear—spot valuations do not mean tighter funding standards. The spot or smoothed rate only relates to when contributions are due. As interest rates rise, a spot rate will result in smaller contributions and vice versa. Over the long-term, contributions will essentially be the same regardless of whether a spot or smoothed rate is used.

Further, spot valuations would not add any appreciable accuracy. Pension liabilities span many years and spot valuations are not meaningful for these liabilities. A spot interest rate for 90 days is simply not a particularly accurate measure of liabilities that in many cases span more than 40 years.

Spot rates would also have very negative implications for the U.S. economy. Spot valuations likely would require larger contributions during economic downturns and smaller contributions during economic upturns. Larger contributions reduce capital spending. This exaggerates downturns and upturns. The result is that the economy overheats during upturns and has deeper recessions during downturns. The two key elements of smoothing under the current rules provide a significant counter-balance to this phenomenon, and should be preserved.

Some have suggested that defined benefit plans can manage the spot rate by investing in bonds and financial derivatives that hedge against interest rate movements. Hedging in this way would be *very expensive*. Plans should not be effectively forced to incur this cost. Over time, pension plans earn more on investments in equities than in bonds. If plan earnings decline because plans are compelled to invest in bonds or other low-yielding instruments, plans' overall costs will rise. As plans become more expensive, it goes without saying that there will be fewer plans remaining and that the heightened cost will discourage employers from increasing benefits in the plans that do remain.

Further, if a fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it could have a marked effect on the stock market, the capital markets, and capital formation. At the end of 2003, private-sector defined benefit plans held equities worth about $900 billion and the market impact of a portfolio shift of this magnitude is extremely difficult to predict.

Moreover, it is far from clear that plans can insulate themselves from both volatility and liability by investing in bonds. First, it is doubtful that there could ever be enough high-quality corporate bonds, particularly at the long durations that characterize pension liabilities. Second, even if there were enough high-quality bonds to go around, it is not possible to immunize all risks. Even the staunchest bond proponents acknowledge that there are numerous pension liabilities that cannot be immunized. For example, because mortality cannot be predicted with precision, it is not possible to immunize a plan that makes life annuity payments. Similarly, the number of people who retire and take available subsidies can only be estimated and thus that liability cannot be immunized.

Avoiding Unnecessary Complexity and Lack of Accountability

We are also concerned that the Administration's yield curve would add significant complexity without providing any real benefit. The proposal would generate numerous different interest rates for each participant. This level of complexity could be managed by some large companies but it will impose an unjustifiable burden on small and mid-sized companies across the country.

Further, we are concerned that the interest rate constructed by the Treasury Department would be opaque. The markets for corporate bonds of many durations are so thin that the interest rates used would actually need to be "made up", i.e., extrapolated from the rates used for the other bonds. Considerable discretion is exercised in creating a yield curve and, in some respects, it appears to be as much art as science. This type of a discretionary, non-market interest rate would be virtually impossible for employers to model internally as part of corporate planning and would also be particularly difficult for Congress to oversee.

Ensuring Appropriate Funding

We are also deeply concerned that the yield curve aspect of the proposal could produce an effective interest rate for some plans that is too low and therefore will overstate liability. Relative to the weighted long-term corporate bond rate in effect this year, the Administration's proposal could increase pension liabilities for some mature plans by 10% or more. In some cases, the immediate liability increase could be even greater. These dollars are far in excess of what is needed to provide a high degree of certainty that plans have enough to pay benefits.

The consequences of excessive contribution obligations are painfully clear. This is precisely what happened when inflated pension contributions were mandated by the obsolete 30-year Treasury bond rate. Employers that confront inflated contribution obligations will have little choice but to stop the financial bleeding by freezing or terminating their plans. Both terminations and freezes have truly unfortunate consequences for workers—current employees typically earn no additional pension accruals and new hires will not have a defined benefit plan whatsoever. Government data reveals that defined benefit plan terminations accelerated prior to the temporary long-term corporate bond rate fix in the Pension Funding Equity Act of 2004, with a 19% drop in the number of plans insured by the PBGC from 1999 to 2002. Just as troublesome, the statistics above do not reflect plans that have been frozen. While the government does not track plan freezes, reports make clear that these freezes were on the upswing.

Further, inflated pension contributions divert precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers will not hire new workers, invest in job training, build new plants, and pursue new research and development. Furthermore, inflating pension liabilities and forcing unnecessary contributions would drive up the cost of doing business and will put U.S. companies at a competitive disadvantage relative to foreign corporations that do not have similar obligations. For these reasons, it is important for funding to remain rational, predictable, and stable. These are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, generate robust economic growth, and keep U.S. companies competitive in the global marketplace.

Preventing unnecessary bankruptcies

It is important to recognize that an employer's credit rating is not directly tied to the plan's ability to provide the promised benefits. The plan is a separate entity and one of the hallmarks of U.S. pension law is that pension assets must be held in a separate trust or similar dedicated vehicle. A plan that has assets sufficient to pay benefits will pay those benefits even if the plan sponsor does not have adequate assets to pay its debts or otherwise has debt that is rated below investment grade.

The Administration's package of proposals creates a serious risk of forcing unnecessary bankruptcies. Its proposals trigger variable funding rules based on the determination of the creditworthiness of the plan sponsor and the members of the sponsor's controlled group as well as to base PBGC premium taxes and benefit guarantees on credit ratings are wrongheaded. In effect, the employer's liability is treated as increasing when the employer's credit rating slips, even though the plan's benefit payment obligations remain unchanged.

The use of credit ratings to determine funding or PBGC premium obligations could have significant macroeconomic effects. Such use would put severe additional pressures on employers experiencing a downturn in their business cycle. If the lower credit ratings create additional funding burdens and business pressures, that could lead to further downgradings, creating a vicious circle that drags a company down. This could well happen to a company that today is able to fund additional contributions to pull itself out of the underfunding problem and thus raise its credit ratings. In short, a creditworthiness test would make it more difficult for a struggling company to recover. That is not in anyone's interest, including the PBGC, which could be forced to assume plan liabilities if the company does not recover. We must be careful not to lose sight of the fact that the best insurance for plans, participants and beneficiaries, and for the PBGC is a healthy plan sponsor. The best way to protect the PBGC is to ensure that plans are appropriately funded, regardless of the plan sponsor's credit rating.

It is also clear that the PBGC's proposal would classify many plans as at risk that will never be terminated. The mere fact that a company's debt is not rated as investment grade does not mean that it will terminate its plans. However, the consequence of these "false positives" could well be self-fulfilling, with employers forced to terminate as a result of a downward spiral. Moreover, employers that have non-investment grade debt but are improving their situation would get no credit for such improvement.

In addition, there are only a handful of credit rating entities and we are also concerned that a creditworthiness test would inappropriately vest these entities with enormous power. This is particularly troubling at a time when the credit rating agencies, and the credit rating process itself, have been the subject of significant criticism. These criticisms have raised questions about the credibility and reliability of credit ratings. In this context, a creditworthiness test is ill-conceived.

Finally, we also note that a creditworthiness test would inevitably result in the government determining the creditworthiness of at least some American businesses. Many privately held employers are not rated by any of the nationally recognized agencies and the PBGC has recommended conferring regulatory authority to develop guidelines for rating private companies. This would be disturbing.

Eliminating Prefunding Barriers

One aspect of the Administration's proposal that we strongly support is the proposal to reform the tax rules governing the deductibility of pension plan contributions. Specifically, we support the Administration's proposal to increase the deduction limits from 100 percent of current liability to 130 percent. In fact, we would recommend increasing the 130 percent figure to 150 percent to ensure that there is an adequate cushion. For deduction purposes, current liability is today based on the 30-year Treasury bond rate, not the long-term corporate bond rate. Under our proposal, current liability would in the future be based on the long-term corporate bond rate for all purposes. This would, in isolation, actually decrease the deduction limit for many plans by 10 percent or 15 percent (and by more for a few plans). Accordingly, to ensure that the deduction limit for most plans is increased by 30 percent compared to current law, the limit should be increased to approximately 150 percent.

We also support repealing the excise tax on nondeductible contributions with respect to defined benefit plans. The excise tax on nondeductible contributions only discourages employers from desirable advance funding. Finally, we support repealing the combined plan deduction limit for any employer that maintains a defined benefit plan insured by the PBGC. Under present law, if an employer maintains both a defined contribution plan and a defined benefit plan, there is a deduction limit on the employer's combined contributions to the two plans. Very generally, that limit is the greatest of:

(1) 25 percent of the participant's compensation,

(2) the minimum contribution required with respect to the defined benefit plan, or

(3) the unfunded current liability of the defined benefit plan.

Without repeal of this provision, the sponsor of a plan with large numbers of retirees might lose its ability to make deductible contributions to its defined contribution plan because, in a mature plan, the number of active participants is small compared to the number of retired participants. This deduction limit can also cause very significant problems for any employer that would like to make a large contribution to its defined benefit plan. There is no supportable policy reason for preventing an employer from soundly funding its plan. Defined benefit plans and defined contribution plans are each subject to appropriate deduction limits that are based on the particular nature of each type of plan. There is no policy rationale for an additional separate limit on combined contributions.

Encouraging Advance Funding

We are also concerned about elements of the Administration's funding proposal that could discourage employers from contributing more than the minimum required contribution. Under current law, if a company makes a contribution in excess of the minimum required contribution, the excess plus interest can be credited against future required contributions. This credit for prefunding ("credit balances") helps to mitigate volatile and unpredictable funding requirements by allowing and encouraging a sponsor to increase funding during good times. The proposal, however, does not give employers who prefund direct credit for their excess contributions.

There have been suggestions that the current law credit balance system has been a factor in terminating plans assumed by the PBGC. These suggestions ignore the fact that but for the credit balance system, companies would have contributed less, resulting in more underfunding and more liabilities assumed by the PBGC.

Critics have also pointed out that credit balances are not immediately adjusted if the underlying value of the assets decreases. Consequently, plans with poor investment results have been able to use credit balances that are larger than the assets they represent. We support carefully targeted reforms that address this investment result problem. These reforms must be administrable and need to be applied prospectively. It would be fundamentally unfair to change the rules retroactively for employers that made contributions in reliance on current law credit balance rules. It is critical, however, that we preserve appropriate incentives to advance fund. Without these incentives, there is a significant risk that employers will only prefund to the minimum required by law. The result would be a less well-funded system, which is in no one's interest.

Providing Timely and Appropriate Disclosure

We believe that participants should have timely and high-quality data regarding the funded status of their plans. It is important that participants have the information they need to evaluate their retirement security. These rules should be structured to provide full and fair disclosure without creating undue administrative burdens on plans or causing unnecessary concerns among participants.

In this context, existing disclosure requirements should be enhanced, while at the same time avoiding the creation of costly and confusing new requirements. A starting point might be the Administration's general proposal to improve the summary annual report ("SAR"), but with significant modifications that would make the information disclosed more immediate and more meaningful. One of the problems with the SAR under current law is that the information disclosed is not timely, a problem which is not addressed by the Administration's proposal. In fact, currently, the information provided can be almost two years old. Accordingly, we would propose stronger changes.

One possible solution would be to require plans to disclose in the SAR their funded percentage. However, instead of reporting percentages as of the first day of the plan year for which the SAR is provided (information that is almost two years old), the percentage could be reported as of the first day of the subsequent year, using (1) the fair market value of assets as of that date and (2) the liabilities as of that date based on a projection from the preceding year. This would mean more timely disclosure. A plan maintained by a public company could also be required to disclose the year-end funded status of the plan as determined for purposes of financial accounting for the two most recent years available. This approach would provide much more information than under present law or under the Administration's proposal. In addition, unlike the Administration's proposal, financial accounting information that is already circulated and disclosed for the company as a whole could be disaggregated into the amounts for individual plans and provided to participants. By using information available to employees through financial reports and media statements, the possibilities for confusion would be greatly reduced.

Funding the PBGC appropriately

The PBGC has proposed dramatic increases in premiums in order to address its deficit. This proposal gives us great concern for several reasons. First, the proposed increase in the flat dollar premium from $19 to $30 and its indexing is strikingly inappropriate. This is a substantial increase on the employers that have maintained a well-funded plan through a unique confluence of lower interest rates and a downturn in the equity markets. It is wrong to require these employers to pay off the deficit created by underfunded plans that have transferred liabilities to the PBGC. Second, the unspecified increase in the variable rate premium will become a source of great volatility and burden for companies struggling to recover. This could well cause widespread freezing of plans by companies that would otherwise recover and maintain ongoing plans. Many of these plans are well-funded by any other measure, but under the proposal might be deemed "underfunded" and now be required to pay variable rate premiums on top of this higher base premium. This would only be exacerbated by the fact that the PBGC has proposed an unprecedented delegation of authority to its Board, rather than Congress, to determine the required premiums. Third, a premium increase misses the point. The solution to underfunding is better funding rules, not higher premiums.

We are also very concerned that PBGC premium increases not become a tool that is used to reduce the Federal budget deficit. The Administration's FY 2006 budget reflects a $26 billion increase in revenue attributable to the PBGC's premium increase. Proper pension policy should be driven by what is best for American workers and retirees, not by the need to fill an arbitrary hole in the federal budget.

More generally, there has been a striking lack of clarity about the real nature of the PBGC deficit. The PBGC has reported a $23 billion deficit as of the end of FY 2004 but there are a number of questions about the PBGC's situation. First, nearly three quarters ($17 billion) of the PBGC's reported deficit represents "probable" terminations rather than claims from plans already trusteed by the PBGC. Second, the PBGC's numbers are based on a below-market interest rate and the deficit would be substantially less using a market-based interest rate. Third, swings in the PBGC surplus-deficit do not provide Congress with an accurate picture of the PBGC's ability to pay benefits. In fact, the PBGC can pay benefits for many, many years into the future. Finally, it is not clear why the PBGC has unilaterally moved away from equities to lower-earning investments that hinder its ability to reduce its deficit. No one denies that the PBGC faces a serious situation, and our comprehensive proposals for funding reform are evidence that the employer community is serious and committed to shoring up the PBGC's financial condition. However, these are troubling questions that should be addressed before taking the very harmful step of increasing PBGC premiums.

Confirming the Legality of Hybrid Plan Designs

Hybrid defined benefit pension plans, such as cash balance and pension equity plans, were developed to meet the needs of today's mobile workforce by combining the best features of traditional defined benefit plans and defined contribution plans. Nearly a third of large employers with defined benefit plans maintain hybrids and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than 7 million Americans as of the year 2000. These plans are defined benefit plans and many of the same funding issues described above are relevant. They also face unique issues.

Despite the significant value that hybrid plans deliver to employees, current legal uncertainties threaten their continued existence. As a result of one court decision, every employer that today sponsors a hybrid plan finds itself in potential legal jeopardy. It is critical that this uncertainty be remedied. Pension reform legislation needs to clarify that the cash balance and pension equity designs satisfy current age discrimination and other related ERISA rules. In addition to clarifying the age appropriateness of the hybrid plan designs, we believe it is essential to provide legal certainty for the hybrid plan conversions that have already taken place. These conversions were pursued in good faith and in reliance on the legal authorities in place at the time.

Some in Congress are seeking to impose specific benefit mandates when employers convert to hybrid pension plans. For example, some would require that employers pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others would require employers to provide employees the choice at the time of conversion between staying in the prior traditional plan or moving to the new hybrid plan. We strongly urge you to reject such mandates. Mandates are fundamentally anathema to the voluntary nature of our employer-provided retirement system. Inflexible mandates will only drive employers from the system and reduce the competitiveness of American business. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans.

Making the EGTRRA changes pernament

As mentioned above, EGTRRA included provisions that increased a number of the defined benefit plan limits. We appreciate that this Committee played an important role in enacting EGTRRA and we believe these improvements have led to growth in defined benefit plan coverage among small employers. These improvements will expire in 2010 unless extended by Congress. These changes have been an enormous success and we strongly support making these provisions permanent.

Conclusion

The myth that defined benefit plans are lumbering towards extinction is exactly that—a myth. Defined benefit plans are a vital part of our national retirement income security system today and they can continue to be part of our future. In recent years, the defined benefit system has been burdened by expensive and excessive regulation, temporary rules, unpredictable and volatile contribution obligations, unnecessary barriers to pre-funding, and legal uncertainty regarding the status of cash balance and other hybrid plans. Reform needs to address these issues and allow the defined benefit system to grow and regain its vigor.

Other reforms are needed to address the reported deficits at the PBGC. We support targeted reforms, including enhanced disclosure, restrictions on benefit increases in appropriate circumstances, and increased opportunities to make contributions during good economic times. The Administration's reform proposal would, however, tear down the entire funding system, build a new system from scratch, and create considerable barriers to sponsoring a defined benefit plan. We believe the system can be strengthened without tearing down a system that is a core part of how employers provide, and millions of Americans receive, retirement income security.

Chairman CAMP. All right. Thank you for your testimony. I didn't know that this hearing would be colorful, but, Mr. Eickelberg, you have managed to make it such. In looking at the President's proposal, there are public disclosure provisions and aspects, and I guess this question is for the whole panel, and I guess that would be analogous to free speech in Pensionville. Do all of you support the public disclosure aspects or provisions in the proposal or, if you don't, what are your concerns? Why don't we start with you, Mr. Gebhardtsbauer?

Mr. GEBHARDTSBAUER. Sure. The Academy supports the disclosure ideas that the Administration has put forth. In fact, they would probably even make them stronger by saying that all plans should have to provide estimates of the funding levels at the end of the year. These estimates are already made for financial statement purposes. A similar estimate could be made without, you know, much additional work and provide it to employees. So, we think disclosure is a good thing for employees.

Chairman CAMP. All right. Mr. Weller?

Mr. WELLER. I agree that more transparency is to the benefit for everyone—employees and for companies as well.

Chairman CAMP. Mr. Eickelberg?

Mr. EICKELBERG. Mr. Chairman, I just want to take a second and address your question as fully as I can. I am not against a pension plan and neither is my company, but what we disclose is information that we know is true and accurate. We do that after we do an audit of the plan. So, we have to have our accountants come in and do an audit, and they do it at the end of the year. If it is a 2004 plan, they are generally doing our company's audit that we have to file, according to the SEC requirements, now on an accelerated basis. It is the same team of people. They will come in. So, they don't start those audits until April, May, and June, and we are hustling like crazy to get the 5500s done. In our case, our corporation does over 100 5500s. We do over 100 audits. The information that we provide to our participants today is based on the information that comes off of our plan audits that then feeds into the 5500s and is filed with the Department of Labor. It is going to be tough for us to accelerate it. No one is against disclosure. I just think it should be accurate and meaningful.

Chairman CAMP. I appreciate that. Another provision, basically, says that a plan cannot increase through pension benefits if they haven't met the solvency test. I realize we are going to be talking about what kind of solvency test that is going to be, but I am interested in your thoughts on just the concept of this proposal in the bill that would—in the Administration's plan that no pension benefits would increase if the solvency test isn't met. I would like to hear all three of your comments on that. Mr. Gebhardtsbauer?r?

Mr. GEBHARDTSBAUER. The Academy generally doesn't take positions, but in this particular situation we appreciate why the Administration would want to do that, not only for increasing benefits, but also every day that the plan is not frozen, benefits are increasing. I think the Administration also has a provision that if you are even lower funded, or if you are in bankruptcy, that you wouldn't be able to even have your accruals continue. There is a real concern if an employer allows the benefits to improve every year, accrue and maybe even increase benefits and not have to even make a contribution—for instance, if they are in bankruptcy, there can be a real concern there.

Chairman CAMP. All right. Mr. Weller, any thoughts on that?

Mr. WELLER. Yes, I think the concern also holds on the other side. Those pension plans or pension benefits are deferred compensation, shifting basically to an outside standard, saying you cannot increase benefits that are promised or negotiated for—shifts the balance of power toward the employer and shifts the balance within the collective bargaining process in many plants. I think there is some danger on the other side, too.

Chairman CAMP. All right. Mr. Eickelberg?

Mr. EICKELBERG. Mr. Chairman, we are obviously very interested in a rational system. We are not interested in bad behavior, whether it is on one side or the other. I think that a proposal like that certainly has merit, and I think we as an employer community need to understand what the ramifications are.

At General Dynamics we are represented from the International Association of Machinists and Aerospace workers (IAM), the United Automobile, Aerospace, and Agricultural Implement Workers (UAW), and the Steelworkers. These are good people. I talk with them all the time about their benefits, and they are very concerned about all of these issues. They do, in their world—their world revolves around packages, pay and benefits, and I would hate to see the United States government interfering in that relationship. I just don't think it can be healthy.

Chairman CAMP. All right. Thank you. Mr. McNulty may inquire.

Mr. MCNULTY. Well, we have clearly heard two very different reactions to the President's proposal today in these two panels. Mr. Belt especially, in the first panel, seemed to indicate that he felt that the President's proposal is just what the doctor ordered, and I would say at least two of the Members of this panel are saying that it will make the patient even sicker. Rather than ask you to reiterate why you think the President's plan is a bad plan, I would just say that if what Mr. Weller said is the right way to go—is not the right way to go, what is the positive plan? What is the alternative vision? If the President's plan is the wrong way to go, which is the right way to go? Let me start with Mr. Eickelberg, please.

Mr. EICKELBERG. Well, the groups that I represent have spent a lot of time looking at these issues. I can tell you from General Dynamics' standpoint. Our plan started in 1943. So, when we talk about smoothing versus spot rates and so forth, we don't think about it in those terms. We worry every bit as much about what is going to happen in 10 to 20 years as we do today. We have to. That is how we look at the plan.

We have enough investment income to keep paying our annual benefits. We are not out liquidating investments in order to meet our pension payments, and it is really two different views of what is happening. If you really believe that the defined benefits system needs to be extinguished, the proposal that they have would minimize any potential impact to the government, it is not going to encourage people to stay in the system. More smoothing would help—not make things worse. They don't like smoothing because they view it as not transparent to what is going on in the real world.

However, if I have got an auto worker who works for me for 35 years, they promised the benefit—a lot of them get paid benefits for more than they have ever worked for us. They will get paid benefits for 30 years and get 20 years of service in with us. That is how we are funding. We are funding over a long period of time. We are not looking at every minute—well, do we have enough money if we decided to end the plan today? Things go up and down. Five years ago, this month, the NASDAQ hit its high. Five years ago today, the PBGC had more money than they knew what to do with. There was talk, around this town, about reducing the PBGC premiums. It didn't go anywhere. Mr. Weller mentioned it a minute ago. In a three-year span, the last 75 years, Mr. Gebhardtsbauer has a chart on it, and in 3 years from 2000 to 2003 you had the occurrence of interest rates going down, which jacked up the liabilities, and you had stock market losses, which reduced the value of the assets. So,, you got a double-whammy. In most cases, when the stock market goes down, interest rates go up. When interest rates go up, that means the pension liabilities go down.

Mr. MCNULTY. The clock is running, but I would like to hear briefly from Mr. Weller and Mr. Gebhardtsbauer.

Mr. WELLER. I think we need to establish a set of rules that is consistent with the long-term nature of a pension plan. Typically, the duration of pension liabilities is about 20 years, so I think it makes sense to reflect that in the valuations of both the liabilities and the assets. We are proposing to average interest rates over 20 years, as well as assets, assuming that assets will ultimately come to equilibrium over a 20-year period. Both in our model simulations have substantial effects. You are not giving anything for free to the employers, but you are just shifting the burden during the business cycles toward the good times, away from the bad times.

Mr. GEBHARDTSBAUER. The Academy would note that there are different ways of doing the smoothing of a contribution. You could do it like the Administration proposal, and use market assets and market liabilities, but somewhere in the calculation of the contribution you need some smoothing. We suggested that you could start with the Administration proposal, but then smooth the contribution of it at the end so that it doesn't increase by a huge amount in any one year. For instance, if your health costs went up 25 percent this year, it is just amazing. Then to find out, maybe your pension contribution could double. You will not want to have a DB plan if it is going to double. There are ways that could temper those increases in contributions. Alternatively, you can smooth the assets and liabilities, or you could smooth the funding ratios. We are happy to work with you in any way that you want to do it, but somewhere you need the smoothing or employers—but a lot of them are going to get out.

Mr. MCNULTY. Thank you. I thank all of you for your testimony today. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Ms. Hart may inquire.

Ms. HART. Thank you, Mr. Chairman. I guess I am going to go back to—I am sorry I wasn't here for the first half of the hearing, and I have a lot of reading to do to catch up. However, Mr. Eickelberg, you indicated in your written testimony that the current 4-year weighted average of the long-term corporate bonds rate is a realistic measure for future pension liabilities. For a well-funded plan with average liabilities of long-term duration, a corporate bond may be sufficient to ensure adequate funding. What about mature plans that have significant short-term liabilities? That is mainly what we are facing, in my area at least. Is there a risk that using a long-term discount rate to value short-term liabilities might result in underfunding?

Mr. EICKELBERG. Well, you owe a certain amount of money that you are going to have to pay out in the future. You don't owe it today. You owe it in the future, and so today, you could say, well, it has got a value of X. Tomorrow with a different interest rate it will have a value of Y. However, you really will owe money out in the future. The more the emphasis that you put on the here and now, the more volatile you make the system. Essentially what the government would like to do is change the pension system from a whole life strategy, where you have cash buildups and you can use that to pay for your cost to your coverage, and go to term insurance, where you just pay how ever much you owe for that year. At some point the cost of that gets too prohibitive and people drop out.

I can tell you from my colleagues in the business community that is exactly what this proposal is going to do. They have—the PBGC and the—has assured Congress in no uncertain terms that they are going to shore up the pension community, and it has withered over the last 20 years. This proposal is going to do nothing more than finish it off, and you will be left with the weakest plans, because there will be no one around—strong plans like General Dynamics and others will not be around to do that.

Ms. HART. What about the plans that we have now that you can—first of all, I take issue with your statement, that if you only look down the road, at the money down the road, that is down the road. You still would have to have some way to actually handle that. We are dealing with the same thing with Social Security. We know there is going to be a problem, so there has to be some mechanism to prepare.

Mr. EICKELBERG. I totally agree. If what we are saying is you owe money in the future, then let us find a reasonable way to fund it. Let us not do it on a process that says, well, let us assume that you are going to not be able to be around to pay it. The issue of hundreds of thousands of plans have ended in the last 20 years that did not wind up on the desk of the PBGC. Where did they go? What are they doing? Those workers now have the sole investment risk for their own retirement. There is no professional money manager watching them. Sure, you hope they have got their money in the right accounts, but in a corporation like ours and others, we have got professional money managers that are there to watch that stream of payments. Plans do not go broke. Employers go broke. There are a lot of creditors that got hurt when USAir went under in addition to the PBGC.

Ms. HART. Thank you. I yield back.

Chairman CAMP. Thank you. Ms. Tubbs Jones may inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman. I want to go back to the subject matter I hit with the last panel, which was cash balance plans. Do you have that at your company, Mr. Eickelberg?

Mr. EICKELBERG. No, we don't, but a lot of companies do.

Ms. TUBBS JONES. Do you have a position with regard to that?

Mr. EICKELBERG. Yes, I think it is another type of defined benefit plan, and I think the uncertainty around those plans just further exacerbates the situation. Nobody knows—nobody is sure of what they are doing. They thought what they were doing was legal, and now they are not so sure any more.

Ms. TUBBS JONES. So, you are one of those who is waiting for some guidance with regard to cash balance plans, even though your company doesn't have one, just for purposes of discussion?

Mr. EICKELBERG. Ben Franklin said long ago we can only give counsel, we can't give conduct. We need direction.

Ms. TUBBS JONES. Thank you, sir. Mr. G—I don't know what—I know they have been calling you your whole name but——

Mr. GEBHARDTSBAUER. That is all right, I have been called that the first 8 years of my life, without the Mr.

Ms. TUBBS JONES. Same question.

Mr. GEBHARDTSBAUER. Traditional pension plans give a lot of benefits who are in their older ages, people who will stay at the company for 30 years, but a lot of companies found they have a much more mobile work force over the last 10 years, and that the traditional plan didn't fit them. Now, they could have gone to a defined contribution plan, and that would have given all the risk to the employees, but instead they decided to switch to a cash balance plan. So, it was valuable to their mobile employees, and it was also very transparent so they could understand it.

Now, Treasury has put out a proposal, as mentioned in the first panel, on here are some different ways to clarify these cash balance rules, because there is all this uncertainty that Henry was just mentioning. So, employers don't want go into it unless they know it is more certain. So, we really need something made more clarifying before employers do it. Some of the ideas in the Treasury proposal I think employers would encourage employers to go in, but there are some issues there, too, that are not addressed. For instance, they don't speak to what would happen to all the cash balance plans in the past. So, there is a lot of concern on the uncertainty there. In addition, they have a requirement called the five-year maintenance rule, so that any time you want to change to a cash balance plan, you would have to maintain the old plan for 5 years. So, a lot of employers are very concerned about that idea in the Treasury proposal, too, because you need to be flexible in this market today. You have new competitors coming up and competing with you without plans. So, to have a proposal that would mean you would have to save it, keep your plan for another 5 years the way it used to be, would make it very difficult. So, it is going to be a difficult decision, exactly how to clarify these rules for cash balance plans, but it is definitely needed.

Ms. TUBBS JONES. Mr. Weller?

Mr. WELLER. Well, I think the uncertainty is more on the employees. What will happen when a company switches from a traditional DB plans to cash balance plan, what will happen to their average benefit levels? As I said before, this is deferred compensation, these are benefits that have been promised, and I think the uncertainty is really what will happen when the employer switches from one plan to the cash balance plan. So, I think we really need to have rules that would ultimately help to protect employee benefits that have been promised to them.

Ms. TUBBS JONES. This is a tough time for workers. When we were questioning what is happening with pension plans, and some are questioning what is happening with Social Security, and very few have savings plans when you talk about a three-legged stool for trying to take care of your retirement. So far, the best thing going is Social Security. At least it is guaranteed now to 2052. Do you agree with that, Mr. Weller?

Mr. WELLER. I completely agree. I think the Social Security is the most secure of that would be three-legged stool, the most secure leg. It is universal, almost everybody has it. It can pay full benefits up to 2052. Clearly, we have big holes in the private sector, and we need to do whatever we can to shore up the private sector in addition to Social Security.

Ms. TUBBS JONES. This is unusual, Mr. Chairman. I yield the balance of my time. Thanks.

Chairman CAMP. Thank you. Mr. Larson may inquire.

Mr. LARSON. Thank you very much, Mr. Chairman, and I thank the panelists as well. I would like to focus my questioning to Mr. Eickelberg. I was very impressed, first and foremost, with all the testimony, both from an academic and actuarial standpoint, but you are actually a person that manages pensions and you have hands-on knowledge of what could happen. I thoroughly enjoyed your analogy between Pensionville and DCville but, more importantly, your heartfelt concern for not only your employees, but employees that could be impacted. You made two statements—I wish you could elaborate on one—that this plan could result in 300,000 jobs being lost, and that the way that this plan is configured benefits the government. That wouldn't have any downside loss in this and puts companies in a very precarious position. Am I correct in that analogy? Could you expand on both the 300,000 jobs and government's commitment versus what it will do to the private sector?

Mr. EICKELBERG. I appreciate, Congressman—first I appreciate your comments. You know, I tried to think about how I could provide information—I am not an actuary, and I usually consider myself lucky in that regard. No offense, Ron. The bottom line on this is 300,000 jobs is a number that was put out at the request of the Business Roundtable. It was done on a model through the University of Maryland, and, Congressman, I would be happy to get all the specifics of it to your office on it.

Mr. LARSON. Thank you. I would appreciate that.

[The information is being retained in Committee files.]

Mr. EICKELBERG. The reason is that the cash requirements that the proposal would require would take out investments. Now, the money that goes into a pension plan, essentially the employer can't touch it. I mean, Ron talked about a couple of issues. If you get it funded enough, you can use it for retiree, medical and so forth, but you know if it is the difference between being a new plan, buying a new airplane, or whatever, or being put in the pension plan, it is going to go in the pension plan. Then you had another question, I am sorry, sir.

Mr. LARSON. Well, you also said in terms of this plan and to whether or not programs would be frozen, employers would drop out, and so forth, that there is——

Mr. EICKELBERG. There is no question the volatility would—and this just deals with the mechanics of it. The way it works—the way things work—is General Dynamics isn't any different than most major corporations. We are already working on our budget for 2006. The announcements have come out, this is what you have to do, and start getting this in, and here are the deadlines, and start thinking about that, and we are calendar year plan or calendar year employers. So, it is what, 10 months, 11 months ahead of time. I couldn't tell the chairman of our company until the middle of January of next year how much they owed for that year. He is not real happy about finding out after the fact about stuff. He really—especially nowadays with the requirements of—, Wall Street, SEC and Sarbanes-Oxley, they have got their own personal fortunes at risk in this and properly disclosing what the company's prospects look like. What will happen is that the companies that can freeze the plans, they are not going to terminate it, because, as Brad Belt said, that has its own issues with it. They won't terminate it, they will just freeze it, and then they will just let it run down. The bottom line is that benefits stop accruing to those individuals that are in the plan.

Mr. LARSON. How do you explain to workers—and all three of you have mentioned these terms throughout the—apparently, Mr.

Belt doesn't see the same kind of, I think, volatility that you all have expressed. When you go back and talk to people, as all of us do in our districts, and you are saying volatility and smoothing, in their language what would you say to them, Mr. Eickelberg? What should government, what should this Committee be doing in order to protect, in order for people who want to stay in Pensionville and not be—reside there, what do we need to——

Mr. EICKELBERG. Well, most people, they like fixed-rate mortgages because they like certainty. It is not that they don't mind borrowing $100,000 to buy a house. We are not talking about whether we owe it or not; they already borrowed $100,000. It is a matter of how are we going to pay it up. Are we going to pay it off in, you know, over 30 years with some reasonable rate of interest, or are we going to be told this year we owe $20,000, and next year we don't owe any money, and then we don't owe any money, and now we owe $30,000. That is how businesses run. Businesses are in the business of taking risk and taking liabilities. They take risks and liabilities that they can manage.

Mr. LARSON. Thank you, sir.

Mr. EICKELBERG. This is not a good system for them.

Mr. LARSON. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. I want to thank this panel for their testimony as well. Today's Committee on Ways and Means hearing of the Subcommittee on Select Revenue Measures is hereby adjourned.

[Whereupon, at 4:34 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Richard L. Trumka, American Federation of Labor and Congress of Industrial Organizations

The AFL–CIO strongly opposes the Bush Administration's recent proposal to restructure the funding rules and change the federal insurance program for single employer defined benefit pension plans. Taken as a whole, this proposal will do far more harm than good to the defined benefit pension system, weakening retirement security for American workers and retirees.

While purporting to be in the best interests of pension plan participants and beneficiaries, the proposal primarily serves the institutional interests of the Pension Benefit Guaranty Corporation (PBGC) at the expense of participants and beneficiaries. The proposal gives employers new reasons to reevaluate their sponsorship of defined benefit plans, threatening the stability of the defined benefit pension plan system overall.

The proposed changes will increase needlessly the volatility and complexity of the pension funding rules for all single employer plans. The administration's approach would force sponsors to determine a plan's funding status and required contribution amounts based on sudden swings in interest rates and asset values. As a result, employers could face large and unpredictable increases in required contributions during economic downturns, when they are least able to make contributions. Furthermore, requiring use of a "yield curve" to measure pension liabilities will only exacerbate the crisis in our manufacturing sector because of its disproportionate impact on employers with a higher share of older workers.

Equally troubling is the administration's plan to penalize companies when they already are facing financial difficulties. The sharply higher premiums to be paid to the PBGC by companies with underfunded plans—an additional $12 billion over the next five years alone—jeopardize the entire defined benefit pension system by diverting critical dollars that could be used to fund pensions at financially weak companies.

The administration's overall focus on higher premiums is misguided. It fails to address or even acknowledge the root causes of the PBGC actuarial deficit—the collapse of pension plans and companies throughout the steel industry and the ongoing restructuring within the airline industry. And for workers' whose plans are now in jeopardy, the administration offers no plan to save and secure their pension benefits.

The administration also penalizes workers by cutting federal pension guarantees, outlawing benefits that protect workers in the event of a plant shutdown, and restricting the benefits workers earn at companies with financial difficulties. And where workers have formed a union to bargain with their employers, the proposal would interfere with existing collective bargaining agreements.

In sum, the Bush Administration proposal for pension "reform" likely will do more to prompt employers' exit from the defined benefit pension plan system than to shore up workers' retirement security. A strong and vibrant defined benefit pension system is crucial to building real retirement security for working families on top of Social Security and personal savings. It is important that Congress get the details of pension reform right; otherwise, irreparable harm may done to an already fragile pension system. We look forward to working with you to ensure a secure retirement for America's workers, and thank you for your consideration of our views.

Statement of Jolynne M. Flores, American Society of Pension Professionals & Actuaries, Arlington, Virginia

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Finance Committee on several important elements of defined benefit reform. ASPPA is a national organization of almost 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

ASPPA applauds the Committee's leadership in exploring defined benefit funding reform. The Senate Finance Committee's consistent focus on pension issues over the years has advanced improvements in the employer-sponsored pension system, as well as led to an increased awareness of the need to focus attention on the retirement security of our nation's workers. ASPPA looks forward to working with Congress and the Administration on strengthening the defined benefit system.

Maximum Deductible Contribution Limit

The Administration has stated that their defined benefit reform proposal is intended to strengthen workers' retirement security by ensuring that defined benefit plans are adequately funded. To this end, they have proposed a maximum deduction amount using a combination of a plan's new ongoing liability funding target and a 30 percent cushion of such new funding target. ASPPA believes that this new maximum deduction limit does not adequately address the needs of small to medium-sized companies.

For a healthy plan sponsor, the Administration's new maximum deductible contribution would be equal to the present value of all accrued benefits, (assuming a salary increase factorand computed using the proposed yield curve), plus a 30 percent cushion of this amount. The Administration has stated that their suggested reforms to the current defined benefit funding rules, including the maximum deduction rules, ensure adequate funding and would provide greater flexibility for employers to make additional contributions in good economic times.

After close analysis of the Administration's proposed maximum deductible contribution limit, in conjunction with the allowable actuarial assumptions for such a calculation, ASPPA has discovered that in certain circumstances involving small to medium-sized companies, the Administration's proposed maximum deductible contribution limit would actually be *decreased,* rather than *increased,* as compared to current law. This would preclude small- to medium-sized employers from funding their plans sufficiently as they can under current law. Thus, rather than strengthening the funding rules, the proposed reform would, in some cases, actually *weaken* them.

Consider the following example: A defined benefit plan has been established with 21 participants (6 highly-compensated and 15 non-highly compensated), with a defined benefit formula based on 4 percent of average pay for each year of participation up to a maximum of 25 years. Under current law, and based on allowable actuarial assumptions, the maximum deductible contribution that could be made to this defined benefit plan would be $382,914. The maximum deductible contribution allowable under the Administration's formula, based on a yield curve and allowable actuarial assumptions, would be $273,048. This amounts to a funding difference of $109,866, which is certainly significant for a small business. Although this funding difference occurs when a plan is first established, it is important to keep in mind that this funding deficiency will have to be made up later, when the small business may not be in a financially-sound position to do so.

The reason for this discrepancy in the maximum deductible contribution is based on the fact that the Administration's proposal, although allowing for an assumption for salary increases for workers, does not allow the plan to assume salary increases for many small business owners. This is because the Administration's proposal does not permit the plan to assume the statutorily provided inflation increases in the compensation limit for determining benefits [IRC section 401(a)(17)].[1] As a consequence, some plans will not be able to fund for these small business owner benefits, even though the law allows such benefits to be accrued. The resulting funding mismatch is a particular problem for successful small businesses. While some plans would be able to take advantage of the 30 percent cushion provided under the Administration's proposal, many others, such as the small business in this example, would not.

For many small and medium-sized companies, not being allowed to assume the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit will create an inappropriate funding deficiency when a plan is first established. Thus, since the Administration's current proposal effectively discriminates against the benefits of many small business owners, the plan will potentially have a funding shortfall just as it starts. Significantly, under the above example, if the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit were allowed to be assumed, the maximum deductible contribution limit under the Administration's proposal would increase to $363,313, a contribution limit similar to current law.

Based upon these results, **ASPPA recommends** that the Administration funding proposal be modified to permit the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit to be assumed for purposes of calculating the maximum deductible contribution limit in order to assure funding adequacy for all plans, including small businesses. As we have shown, the Administration's proposal would unfairly discriminate against successful small businesses and hinder the creation of new defined benefit plans. Concurrently, ASPPA supports an increase in the deduction limit of a plan's ongoing liability funding target from the proposed 130 percent to 150 percent of such target. By increasing this cushion, employers would be provided with more flexibility in determining their pension contributions, particularly in good economic times. Being able to make additional pension contributions in good times would also be consistent with the Administration's proposal that defined benefit plans be adequately funded.

Disclosure under Schedule B of the Form 5500

A main concern of the Administration is that the asset and liability information provided under the current Schedule B of the Form 5500 annual report/return does not adequately provide an accurate and meaningful measure of a plan's funding status. Under the Administration's proposal, all single-employer defined benefit plans covered under the Pension Benefit Guaranty Corporation (PBGC) with more than 100 participants, and required to make quarterly contributions for the plan year, would be required to file a Schedule B with their Form 5500 by the fifteenth day of the second month following the close of the plan year (if calendar year, February 15). Where a contribution is subsequently made for the plan year, an amended Schedule B would be required to be filed under the Form 5500's existing requirements.[2] Under the Administration's proposal, these plans would be required to use a beginning of plan year valuation.[3]

ASPPA recognizes that while some accelerated information would be helpful to provide an early warning system to protect the PBGC, an expanded exemption from

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[1] The annual compensation limit under the "401(a)(17)" limit cannot generally exceed $200,000, to be adjusted for cost-of-living increases beginning in 2002. The current 401(a)(17) limit for 2005 is $210,000.

[2] Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due seven months after the end of the plan year (if calendar year, July 31), with a two and a half month extension available (if calendar year, October 15).

[3] Under current law, defined benefit plans are allowed to use any valuation date of a plan year for disclosure purposes.

the new Schedule B filing requirement should be made for small to medium-sized plans, similar to the Administration's exemption for plans subject to the at-risk liability calculation based on a plan sponsor's financial health. An earlier reporting requirement for many small to medium-sized plans that do not pose a potential risk to the PBGC would unnecessarily increase administrative complexity and costs. In addition, requiring an earlier valuation date for certain small to medium-sized plans *not* subject to Administration's accelerated filing date would further expand an unnecessary administrative burden on these plans.

ASPPA recommends that only plans with 500 or more participants that are required to make quarterly contributions be required to file a report on the funded status of the plan within 90 (ninety) days after the close of the plan year (if calendar year, March 31). This reporting would be done using a newly-created form Schedule B–1 (which would be filed electronically, if possible) and would provide only the asset and liability information necessary to disclose the plan's funded status as of the valuation date in the prior plan year (retaining the current law structure of allowing any plan valuation date in a plan year.) Any additional reporting information, such as the annual contribution information, should continue to be reported on the regular Schedule B filed with the Form 5500. In addition, we recommend that plans not subject to the Administration's accelerated filing date with less than 500 participants be allowed to retain the current law structure of allowing any valuation date.

Consistent with the interests of the Administration, this new Schedule B–1 would allow the dissemination of more accurate and timely information regarding the funded status of a plan, without causing a substantial administrative or financial hardship on small to medium-sized plans that pose little potential risk to the PBGC.

The Impact of Fluctuating Interest Rates on Lump Sum Calculation

As sponsors of defined benefit plans promise a guaranteed benefit to their participants, a plan sponsor must calculate on a year-by-year basis the extent to which contributions are required to fund those promised benefits. Under current law, when a benefit will be paid in the form of a lump sum—a common occurrence for defined benefit plans—the calculation of the annual contribution requirements consists of several elements. First is the requirement that a promised benefit not exceed a specified amount (the "415 limit"),[4] which is expressed in terms of a life annuity. Second, if a participant in a defined benefit plan elects benefit payment in a form other than a life annuity (*e.g.,* lump sum, term certain), the 415 limit must be converted to reflect this alternative form of benefit.

Prior to 1995, the interest rate assumption generally used when making this conversion was 5 percent. Thus, for example, the 415 limit for a lump sum distribution could be determined mathematically in advance of the participant's retirement. This permitted an employer to know exactly, upon performance of a relatively simple calculation, what its annual plan contribution obligations would be. This was particularly crucial for smaller defined benefit plans, since the payout to even one single participant can have a dramatic impact on overall plan funding, and thus on annual contribution obligations.

From 1995 to 2003, the 415 limit for forms of benefit other than a life annuity was determined by using the 30-year Treasury bond rate, which produced a fluctuating month-to-month interest rate. The Pension Funding Equity Act of 2004 (PFEA 04) amended IRC 415 to provide that for plan years beginning in 2004 or 2005, an interest rate assumption of 5.5 percent was to be used in lieu of the applicable interest rate. This temporary interest rate assumption was a welcome relief to smaller defined benefit plans, as it provided much needed simplicity and predictability in making lump sum calculations.

The Administration's proposal, while not expressly addressing the 415 issue, does not appear to extend this 5.5 percent interest rate assumption in determining the 415 limit for lump sum calculations. Instead, the proposal seems to contemplate that the contribution amount to fund a lump sum payment subject to the 415 limit be calculated by using interest rates drawn from a zero-coupon corporate yield curve.

The complexity of the yield curve calculation would create a significant volatility problem facing small and medium-sized defined benefit plan sponsors. Using the yield curve to determine funding obligations for the 415 limit based on monthly fluctuating interest rates would make it very difficult for smaller businesses to properly fund their plans and virtually impossible to project funding obligations into future

[4] The annual benefit limit under IRC 415 (the "415 limit") is the lesser of (1) 100 percent of the participant's average compensation over the highest three consecutive years, or (2) $160,000 (indexed for inflation), expressed in terms of a life annuity beginning at age 65.

years. It would create confusion to plan sponsors and plan participants whose lump sum payment amounts may bounce up and down as these rates change. It would also cause plans to be unable to reasonably determine their liabilities with regard to benefits payable in a lump sum and other forms of payment.

Affordability issues are also raised—a plan sponsor will justifiably wonder whether it will be able to afford to guarantee the defined benefit. There would be a chilling effect on a plan sponsor's willingness to establish a plan because of the impossibility of predictability for the plan's obligations. The problems arising from being wholly dependent on the whims of a widely-fluctuating interest rate would be a major deterrent to the establishment of defined benefit plans, especially for small businesses.

In order to provide for a more predictable funding requirement for small defined benefit plans, **ASPPA recommends** that the use of the current 5.5 percent interest rate assumption for benefit forms other than a life annuity (*i.e.,* lump sums) for purposes of the 415 limits as set forth in PFEA 04 be made permanent. This use of a flat interest rate would remove the volatility from the determination of lump sums and other form of benefits, ensure consistency for planning purposes, pave the way for the potential establishment of new defined benefit plans by small businesses, and be no more generous than current law.

Reduced PBGC Premiums for Small and New Plans

Finally, while ASPPA agrees that some reform of the PBGC premium structure is necessary to increase the PBGC revenue needed to meet expected claims and improve their underlying financial condition, an exception from the Administration's proposed fixed and risk-based premium (which would replace the current Variable Rate Premium) should be created for small and new defined benefit plans that pose no significant risk to the PBGC. These plans expose the PBGC to little, if any, liability, and accordingly should be charged minimal premiums.

The Administration's defined benefit reform proposal would increase the current fixed rate to reflect the cost of living adjustment (COLA) from 1991, and index the fixed premium thereafter. The Administration would also assess a new risk-related premium on all plans with assets less than their funding target. While the premium rate per dollar of underfunding would be identical for all plans, the Administration has, however, suggested an unorthodox system that would allow this premium rate per dollar of underfunding to be set, reviewed, and revised periodically by the PBGC Board. The Administration represents that these premium increases are necessary to mitigate future losses and retire PBGC's deficit (currently valued at $23 billion) over a reasonable time period.

This new premium structure would create a great deal of uncertainty for plan sponsors every year in budgeting for PBGC premiums. Further, with unprecedented authority being provided to the PBGC Board to set the risk-related premium, there is a potential that these premiums could unnecessarily escalate for certain plan sponsors who do not pose a significant risk to the PBGC, under the pretext of decreasing the PBGC deficit. It would not only force many plan sponsors, especially small to medium-sized companies, to exit the system, it would also restrict the creation of new plans and future PBGC premium-payers.

ASPPA recommends that an exception be provided to small and new plans from these proposed PBGC premium reforms. These two non-controversial exceptions have been introduced by Congressional lawmakers in prior legislation. Most recently, they were included in the Senate Finance Committee's reintroduced pension protection legislation, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act, introduced by Committee Chairman Charles Grassley (R–IA) and ranking member Max Baucus (D–MT) on January 31, 2005. They were also included in the House pension reform bill, the Pension Security Act of 2004 (H.R. 1000), introduced in the 108th Congress by House Education and Workforce Chairman John Boehner (R–OH) and passed by the House on May 14, 2003.

ASPPA proposes for new small plans[5] (maintained by controlled group with 100 or fewer employees), that the premium for each of the first five years of existence be set at $5 per participant with no risk-related premium owed. For new plans that have over 100 participants, the PBGC premium should be phased in at a variable

[5] A new plan means a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as in the new plan.

rate over the first five years (20 percent for first year, 40 percent for second year, and so on).

Further, for very small plans (maintained by controlled groups with 25 or less employees), ASPPA proposes to either: (1) cap their variable rate premium payments for each participant to an amount equal to $5 times the number of plan participants; or (2) allow the exclusion of substantial owner benefits in excess of the phased-in amount from their variable rate premium calculations.

Conclusion

ASPPA appreciates the opportunity to offer its perspective on these very important defined benefit reform issues. We believe any new reforms should be designed to stimulate and protect the defined benefit system. ASPPA looks forward to working with the Committee and the Administration on a comprehensive solution to defined benefit reform.

Statement of Tom Korb, Association for Advanced Life Underwriting, and National Association of Insurance and Financial Advisors, Falls Church, Virginia

The Association for Advanced Life Underwriting ("AALU") and the National Association of Insurance and Financial Advisors ("NAIFA") appreciate the opportunity to submit testimony to the Select Revenue Measures Subcommittee regarding the Administration's single-employer pension funding proposals. AALU and NAIFA wish to comment on one aspect of the Administration's proposals, the proposed restrictions on funding nonqualified deferred compensation.

AALU is a nationwide organization of life insurance agents, many of whom are engaged in complex areas of life insurance such as business continuation planning, estate planning, retirement planning, deferred compensation and employee benefit planning. AALU represents approximately 2,000 life and health insurance agents and financial advisors nationwide. NAIFA (formerly the National Association of Life Underwriters) is a federation of nearly 800 state and local associations representing almost 225,000 members and their employees nationwide. Members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments.

The Administration's Proposal

Under the Administration's proposal, if a financially weak employer (as defined elsewhere in the Administration's pension funding proposal) has a severely underfunded plan, special rules would apply under ERISA that would prohibit the funding of nonqualified deferred compensation for executives. These special rules would also apply to prohibit any funding of executive compensation that occurs less than 6 months before or 6 months after the termination of a pension plan whose assets are not sufficient to provide all benefits due under the plan. Types of prohibited funding in these circumstances would include funding through a rabbi trust, insurance policy, or other funding mechanism that limits immediate access to such amounts by the company or by creditors. These rules would apply to any top executive in any company in the controlled group (or former employee who was a top executive at the time of termination of employment).

A pension plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition. The right would permit recovery of the total amount that was funded, together with attorney's fees. Plan fiduciaries would be obligated, under existing law, to take reasonable steps to pursue the cause of action afforded by this new provision.

This proposed nonqualified deferred compensation funding prohibition would not apply for the first five years after a plan is established.

Concerns Regarding the Administration Proposal

It is the strong view of AALU and NAIFA that the Administration proposal regarding the funding of nonqualified deferred compensation should not be adopted. The proposal would impose unworkable and unnecessary restrictions on nonqualified deferred compensation arrangements without achieving any improvement in the funding of qualified pension plans.

Much of nonqualified deferred compensation is represented by compensation that employees have voluntarily agreed to defer. This is compensation that, but for a deferral agreement, the employee would be entitled to receive as it is earned. One likely consequence of enacting the Administration's restrictions is that potentially-affected executives would simply decide not to defer their compensation. These executives would take current cash compensation rather than risking a future lawsuit by their company's qualified pension plan. In taking currently the compensation they have earned, the executive would actually leave a company whose fortunes subsequently decline with a reduced ability to pay creditors. Indeed current tax law requires nonqualified deferred compensation to remain subject to the claims of the employer's general creditors at all times until it is paid.

The Administration's concept of "funding" for purposes of the proposed restrictions would appear to reflect a misunderstanding of the operation of rabbi trusts and similar mechanisms. Amounts placed in rabbi trusts remain subject to the claims of an employer's general creditors. Thus, in the case of a company in adverse financial circumstances, there is a significant likelihood that amounts in the rabbi trust will never be paid to the employee whose nonqualified deferred compensation benefit is "funded." Instead, the assets of the rabbi trust will be used to pay the company's creditors and the employee will never receive the deferred compensation. There can be no justification for giving the company's qualified pension plan a claim against the employee for compensation that the employee may never receive.

Beyond rabbi trusts, the proposed funding restrictions would apply to situations where nonqualified deferred compensation is funded through insurance policies. The rationale for such a rule is unclear. Companies often purchase life insurance policies as a means of offsetting their future employee benefit (including nonqualified deferred compensation) obligations. There is no justification for creating a cause of action against an employee merely because his or her employer has chosen to offset the cost of future benefit obligations through a life insurance purchase. The proposal is not limited to insurance policies placed in a rabbi trust and thus would affect policies that function like other prudent investments the employer may make. These life insurance policies, like other financial assets the employer may own, are not, in any way, legally obligated to be used to pay nonqualified deferred compensation. Of course, these policies also remain subject to the claims of the employer's creditors.

The Administration's proposal is also, to a significant extent, redundant of existing law, specifically the restrictions on nonqualified deferred compensation funding adopted last year as part of the American Jobs Creation Act of 2004. Under Internal Revenue Code section 409A(b)(2), nonqualified deferred compensation is subject to immediate taxation (and a 20-percent penalty and interest) if a company's assets become restricted to the payment of the deferred compensation (including through a rabbi trust) in connection with a change in the employer's financial health, even though the assets remain subject to the claims of an employer's general creditors. This change adopted last year already effectively prohibits companies suffering a decline from funding nonqualified deferred compensation.

AALU and NAIFA note, as a technical matter, that the Administration's proposal does not define the "top executives" whose nonqualified deferred compensation benefits would be subject to the funding prohibition. In light of the proposed application of the funding prohibition to any "top executive in any company in the controlled group," the group of executives subject to the proposal could be extremely broad in the case of a company with numerous subsidiaries. The proposal could apply to a large number of individuals in a controlled group, including individuals who have no real decision-making power with respect to the overall group or the funding of nonqualified deferred compensation obligations.

The proposal's effective date also raises concerns. The Treasury Department's General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals indicates only that that the "proposal generally would be effective for plan years beginning in 2006." Thus, the funding prohibition would apply without regard to the time at which nonqualified deferred compensation was deferred, and thus would appear to hit even compensation that may have been deferred long before the Administration proposal was advanced. The Ways and Means Committee has a long tradition of avoiding retroactive adverse tax law changes, including in the area of nonqualified deferred compensation. By way of recent example, the nonqualified deferred compensation restrictions adopted as part of the American Jobs Creation Act of 2004 generally apply to amounts deferred after December 31, 2004. The Administration's proposed nonqualified deferred compensation funding restrictions would certainly be inequitable if applied to compensation deferred prior to the enactment of the proposed restrictions.

AALU and NAIFA respectfully submit that the Administration's proposed nonqualified deferred compensation funding restrictions will not achieve their desired purpose of enhancing the funding of single-employer qualified pension plans and should not be adopted.

Committee on Investment of Employee Benefit Assets
Bethesda, Maryland 20814
March 9, 2005

The Honorable Dave Camp
Chairman, Subcommittee on Select Revenue Measures
House Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Please add the Committee on Investment of Employee Benefit Assets (CIEBA) to the organizations endorsing the written testimony of Henry C. Eickelberg submitted to the Select Revenue Subcommittee for the hearing on "The President's Proposal for Single-Employer Pension Funding Reform" on March 8, 2005.

Thank you.

Sincerely,

Judy Schub
Managing Director

Food Marketing Institute
Washington, DC 20005
March 8, 2005

The Honorable David Camp
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Camp:

The Food Marketing Institute (FMI), on behalf of the nation's neighborhood grocery stores, respectfully submits this letter for your hearing record. FMI represents supermarkets and food wholesalers employing 3.5 million associates.

We agree that it is an important time to reform the defined benefit pension system. We respectfully request that your Committee's review cover defined benefit multiemployer plans, as well as single employer plans. The former play an important role in providing retirement benefits for almost 10 million American workers and the laws governing their sound operation need to be revised and updated. We look forward to working with you and your Committee to resolve the fiscal crisis currently facing all defined benefit plans.

Sincerely,

John J. Motley, III
Senior Vice President
Government and Public Affairs

Statement of Emil Wigode, March of Dimes

The March of Dimes is pleased that the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, has called a hearing to examine the issues facing defined benefit plans and the financial health of the Pension Benefit Guaranty Corporation (PBGC). These are areas where improvements can be made. At the same time, it is also essential that any reforms avoid unduly and unnecessarily adding to the burdens of employers that voluntarily sponsor defined benefit plans.

The March of Dimes is a national voluntary health agency whose mission is to improve the health of babies by preventing birth defects and infant mortality. Founded in 1938, the March of Dimes funds programs of research, community services, education, and advocacy to save babies. Since 1948, we have maintained a defined benefit plan for the benefit of our employees.

As the Subcommittee on Select Revenue Measures begins the work of strengthening the defined benefit system, we ask that you carefully consider the impact any pension reform legislation would have on charities and other nonprofit organizations (collectively, "NPOs") that sponsor defined benefit plans.

NPOs face unique challenges as employers that sponsor defined benefit plans. Changes in the state of the national economy or sudden catastrophic events tend to have a greater impact on NPOs' cash flows, on the whole, than other employers. To weather the ups and downs of charitable giving while carrying out our charitable purpose, the March of Dimes must be able to predict, and thus prepare to meet, our basic financial obligations. Among those is our obligation to fund the defined benefit plan that we sponsor for our employees. In our view, the single most important step Congress could take to ensure the continued viability of the defined benefit system is enact a permanent replacement for the obsolete 30-year Treasury bond interest rate used for pension calculations. A permanent interest rate that accurately reflects employers' pension funding obligations is critical to the functioning of the defined benefit system. We commend Congress for enacting a temporary corporate bond replacement rate; however, the temporary rate is scheduled to expire at year-end and the current uncertainty regarding future pension liabilities hampers the ability of defined benefit plan sponsors, like us, to make long-term business plans. An appropriate and permanent interest rate is needed as soon as possible.

We also have concerns regarding some of the Administration's pension funding reform proposals and their potential effect on the ability of NPOs to plan for future pension costs. The Administration has proposed that pension funding liability be calculated using an interest rate based on a spot yield curve. It has also proposed eliminating the smoothing of asset values. As mentioned above, predictability is of the utmost importance for financial planning in today's charitable giving climate and enables us to budget plan contributions in advance. The Administration's proposals could lead to dangerous volatility in funding and premium obligations, without a concomitant increase in accuracy. For that reason, we urge you to maintain the current law practice of smoothing, which promotes long term pension funding stability.

Another unique NPO issue raised by the Administration's proposals is the linking of pension funding obligations to creditworthiness. Under the Administration's proposals, a plan's funding target, contribution requirements and premium obligations would all be tied to its credit rating. However, to date we have not seen any guidance regarding the application of these rules to NPOs or other organizations that do not have public debt subject to a rating.

The Administration's reform proposals would completely overhaul existing pension funding rules for single-employer defined benefit plans. The proposed changes, if enacted, would be the most significant since ERISA was enacted in 1974. It will take time for employers that sponsor defined benefit plans and plan service providers to fully analyze all the implications and interactions of the myriad proposed changes. We hope that before the Committee recommends any pension funding reforms, it will carefully examine each proposal with a particular focus on the potential impact on NPOs such as the March of Dimes. Furthermore, we hope that the effective date for implementation of the proposals will allow adequate time for review and analysis.

Thank you in advance for your careful consideration of the unique nature of our pension funding reform concerns.

Statement of Bob Moore, The Oklahoma Taxpayer, Lawton, Oklahoma

Freedom from Federal Personal Income Tax

President Bush's Inaugural Speech was about FREEDOM. Below are some ways the federal government can create more freedom for the American people.

I was telling a small group of friends about my Eight Year Plan when one lady spoke up to say, "Bob, you do not understand, the Federal Government is not into SIMPLE". I had to agree. I am into SIMPLE. I use the "KIS Theory" Keep It Simple.

First example of SIMPLE is the federal income tax on interest earned on bank accounts. Why have income tax laws for 300 million people when the federal government should have the financial institutions (appr. 10,000) pay a monthly tax being a percentage of the total dollars paid as interest to clients. No tax due from the citizens, the bank pays the tax, SIMPLE.

Same is true with stock dividends, have the corporations pay the government a percentage of the dollar amount paid to the stockholders. No tax due from the citizens, the corporations pay the tax, SIMPLE.

Second example, most taxpayers believe there is at least 2% waste in the federal government. If the President reduced the size of government by only 1.25% each year. That would be 8 X 1.25 = 10% totally reduction in the size of government at the end of eight years. That is a huge 10% savings, just that SIMPLE.

Third example of SIMPLE is the 40–40 Tax on Gasoline. As a child, I asked where does the.9 of a cent go? Years later, I still don't really know. Keep the tax simple and honest such as:

(a) eliminate the.9 cent;

(b) this tax shall not be amended for forty (40) years;

(c) a total tax of forty (40) cents a gallon tax according to the following:

(d) twenty (20) cents shall go to the federal government and

(e) twenty (20) cents shall go to the originating State government

(f) gasoline tax to ONLY go toward roads and bridges.

Fourth example of SIMPLE: Toll Roads, Sales Tax and Income Tax

Can you imagine driving up to the toll booth to pay the toll and the person starts asking you financial questions such as how much money do you make; how many children do you have; how many cars do you own. Then says according to your credits and deductions; the toll will be X dollars.

Next event, you visit Wal-Mart, when you check out, the Cashier starts asking you financial questions to figure out the amount of sales tax you will be charged.

Does this sound silly? Can you image how many people this type of tax system would require? How much un-necessary work this would cause?

Now look at the Federal Income Tax System with all the forms, credits and deductions, etc.

See the comparison? How simple the Federal Income Tax System could be with a flat tax. Our citizens live in fear of the IRS and hate April 15th.

There is a better simpler system available if people will demand it. With the follow system, we could eliminate the dreaded April 15th deadline.

Simple Tax System: Use the right formula then adjust spending to the amount of money collected. Truthful Tax Reform—Federal Tax Payroll Program.

1. "TOTALLY" Eliminate the Personal Income Tax "TOTALLY".

2. Fact: FICA tax is over 15% of the employees' paycheck. Federal Courts have ruled the FICA is a tax not a retirement fund. The Federal Government needs to be honest and declare that FICA tax goes to the general fund to pay for government spending programs. Re-name FICA tax to Federal Tax Payroll Program.

3. Government taxes should be on commission, just like all private businesses and private business' employees. The government spending can only grow if more people make more money.

4. Payroll deduction is the most efficient way to collect taxes. The Federal Tax Payroll Program will be the only federal tax that wage-earning Americans will pay. Never a personal income tax form to file with the IRS.

5. Keep the system simple, one rate for all taxpayers. Ten (10%) Percent is good enough for GOD, then Ten (10%) Percent should be good enough for the government. However the federal government is not as efficient as GOD so lets put the maximum rate at twenty (20%) percent.

6. The Federal Tax Payroll Program shall be 20% "Maximum" of which Ten (10%) Percent to be withheld from the wage-earners' pay to be matched by Ten (10%) Percent from the Employer. Rate shall not be raised ever.

7. Earmark how the money shall be allocated, such as:

(a) 2% to Citizens Retirement Fund, a 401K type program—private social security fund for each person;

(b) 4% to Social Security Fund for Senior Citizens retirement only;

(c) 1% Senior Citizens Medical Fund;

(d) 1% Disability Fund;

(e) 1% Family Dependent Fund;

(f) 1% National Defense and

(g) 10% for the other spending programs.

A total of 20% of the wage-earners' salary to go to the Federal government.

**Would be great if each State Government would "totally" eliminate State Personal Income Tax to be replaced by receiving one (1%) percent of this 20% total.

This type of system would result in no forms, no worry and a much smaller I.R.S. No tax forms to file each year. No tax credits to be given or taken away by the Federal government. No increase or decrease in the tax rate.

This would get the Federal Government out of micro-managing the daily life of the taxpayers. It is called FREEDOM!

Social Security; at this point, the government should just pay everyone the same amount each month once the person has reached age 62 or 65. We are a rich Country and we do not want our Senior Citizens living below the poverty level so yes I would increase the monthly check for all senior citizens.

An advantage given by the government to one person means an unfair dis-advantage to all other Americans. Our Founding Fathers believed that small government and less taxes means more freedom.

Statement of Lawrence N. Bader and Zvi Bodie, Pension Finance Institute, New York, New York

The President's proposal is an important step in the right direction. Unlike many in the pension community, we prefer even more rigorous funding rules to apply after a suitable period of transition. Most of our comments address the permanent post-transition rules that we believe are necessary for a financially sound defined benefit pension system.

Solvency

We believe that pension plan solvency must be the fundamental goal of any pension reform. We can visualize many possible transition arrangements, but reform should require that ***all plans become fully funded by a specified date*** such as January 1, 2015[1] ***and remain fully funded at all times thereafter***. Banks, insurance companies, mutual funds, brokerages, defined contribution plans, and all other financial institutions that serve the public are required to be solvent upon every periodic examination. Why should defined benefit plans be the exception?

Funding below the solvency level is, in effect, borrowing by the plan sponsor from the plan and its beneficiaries. This borrowing is guaranteed by the PBGC—effectively by other plan sponsors and potentially by taxpayers. The involuntary guarantee provided by others encourages weak companies to make large and valuable pension promises to their employees. They also allow sponsors to disregard sound risk management practices and take large investment risks without regard to whether they can make good any possible losses.

Although PBGC guarantees were established as "insurance," the result is really a tax on successful plan sponsors to meet the obligations of unsuccessful ones. True insurance covers independent risks that are difficult for the insureds to control. The vast majority of sponsors insured by the PBGC, though, are deliberately taking the same risk: betting on equities instead of hedging their pension liabilities with bonds.

The Administration proposal addresses solvency more directly than current law and sensibly discards many of the overlapping, even contradictory, rules of the past. Nonetheless, the proposal falls short of ever requiring permanent solvency such as that required of other financial institutions:

- The proposal allows seven-year funding for future losses (primarily due to poor plan risk management), for assumption changes, and for new benefit awards by (presumably) strong companies. These liability increases should be funded immediately.
- The proposal allows plans to measure their liabilities using corporate, rather than risk free, discount rates. Because plan solvency is a bankruptcy issue (when the firm cannot meet its ordinary debts, the plan assets act as collateral for benefits promised by the plan), defining a funding standard using risky debt assures that other parties will pay for some of the promises made by weak sponsors.

Is Rigor Incompatible with DB Viability?

It is a fact that strong funding requirements will cause some sponsors to freeze (and eventually terminate) their DB plans. Some sponsors and other commentators have used this fact as a cudgel to threaten policymakers. The implication of this threat is that DB plans are universally valuable to their sponsors, plan participants, and society. We agree that *well-funded* plans provide excellent value, but poorly

[1] To the extent that some few companies, or even an industry, cannot meet this target date, we suggest that federal tolerance for these companies be offered in the form of loan guarantees that will permit such firms to borrow enough from banks and bond-buyers to fund their plans fully. The current practice of propping up failing firms through their pension plans is a disaster for pension America. If a company or an industry is worthy of public assistance after January 1, 2015, Congress can act directly and transparently to provide support without using the private pension system as a source of corporate welfare.

funded plans are a menace to their sponsors, participants, and society. Accommodating such plans indefinitely is not an appropriate objective for pension reform.

PBGC Premiums and Risks

PBGC premiums must reflect plan risks. Because plan risks depend on sponsor strength in addition to plan factors (funding level and asset allocation), accurate risk assessment might require the PBGC to intrude excessively into the doings of plan sponsors. We prefer to focus on risk elimination through stronger funding standards. A requirement of full funding at all times would eventually reduce the role of the PBGC to collecting the very modest premiums needed to pay for rare accidents, rather than easily foreseen and preventable risks.

Contribution Volatility

Volatility is a property of the capital markets. These same markets have developed hedging and asset-liability management tools to manage volatility. Such tools can be very effective. Artificial tools, developed by actuaries and embedded in ERISA since its inception, however, are counterproductive. They encourage risk taking and moral hazard (clever gaming of the system). Obscuring risk is not the same as managing risk. Every accommodative provision in the administration's proposal serves to perpetuate needless risk taking. All smoothing and off-market values should be eliminated, thereby increasing transparency and relevance. This will simplify the rules, reduce moral hazard, and encourage sound risk management.

Although many commentators claim that full funding and strong asset-liability management are costly to plan sponsors, modern corporate finance principles show that under a sound insurance system, these practices generally ***add*** value for their sponsors.

Credit Balance

The credit balance is a flawed concept in any solvency based scheme. It should be eliminated during the transition.

Maximum Deductible Funding

The proposal allows for a full funding limit equal to 130% of the liability based on service to date with allowance for future salary increases. This amounts to a limit in excess of 150% of the solvency level for many pay-related plans. Although it is argued that companies will overfund in "good times" and thus be healthier in bad times, it is much more likely that companies looking for tax shelter will take advantage of this latitude; companies that have imposed substantial liabilities on the PBGC have typically funded at minimum levels for many years prior to their failures.

Excise Tax Reform

Those who advocate generous tax-deductible maximums also favor repeal of the excise tax on surplus asset reversions. This combination asks taxpayers to allow management to shelter excess cash flow, invest it riskily, and recover it without penalty. We favor reduction or even elimination of the excise tax but do so only in combination with maximum deductible limits in the range of 120% to 125% of solvency.

Society for Human Resource Management
Alexandria, Virginia 22314
April 6, 2005

The Honorable Dave Camp
Chairman
Committee on Ways and Means
Subcommittee on Select Revenue Measures
1102 LongworthHouseOfficeBuilding
Washington, DC 20515

HR Professionals Support PBGC Solvency & Shoring-up DB Plans

Chairman Camp and Ranking Member McNulty:

The Society for Human Resource Management (SHRM) applauds your collective efforts over the past several years to craft legislation that will ensure the integrity of the defined benefit (DB) pension system and the solvency of the Pension Benefit Guarantee Corporation (PBGC). SHRM and its members remain committed to a flexible pension system that meets the retirement needs of its workforce and the financial goals of its organizations. Specifically, SHRM wants to make sure that pension promises are kept and pension plan requirements are equitable yet effective.

The Society for Human Resource Management (SHRM) is the world's largest association devoted to human resource management. Representing more than 190,000 individual members, the Society's mission is to serve the needs of HR professionals by providing the most essential and comprehensive resources available. As an influential voice, the Society's mission is also to advance the human resource profession to ensure that HR is recognized as an essential partner in developing and executing organizational strategy. Founded in 1948, SHRM currently has more than 500 affiliated chapters and members in more than 100 countries.

As public and private employee benefit plan sponsors, managers and administrators, HR professionals are intimately involved in all aspects of pension plan management and administration. We appreciate this opportunity to share with you our thoughts on the Administration's proposal to strengthen funding for single-employer pension plans and offer the following specific comments on the Administration's proposal:

Improve Disclosure

The Administration proposes to provide increased information about a plan's funding status and timelier plan funding information. SHRM supports increased disclosure to plan participants on plan funding and financial status but remains concerned that some information or actuarial calculations may be overly complex for both plan sponsors and plan participants. SHRM is worried that complex actuarial assessments or assumptions, without comprehensive and lengthy explanations, may lead to confusion. Such false impressions or misunderstandings about plan solvency could generate unwanted economic market fluctuations, inconsistent industry information, and undermine confidence in the plan's solvency.

Determining Liabilities

The Administration proposes to base the interest rates used for present value calculations for pension funding obligations on a yield curve valuation. SHRM supports using a more accurate valuation method as it provides a better indication of a plan's obligations. However, we are hesitant to fully support the yield curve valuation method because it potentially introduces increased volatility in assessing plan liabilities. Plan liabilities would become dependent not only on fluctuations in interest rates but also on changes in the shape of the yield curve and on changes in the duration of plan liabilities. This type of volatility in pension obligations undermines employers' ability to predict and budget their costs and has already been a significant deterrent to organization's retaining DB plans as a retirement plan option. SHRM believes there are alternate valuation models that approximate the effect of a yield curve without adding as much complexity to the calculations or actuarial volatility; which if continued would maintain the current trend of employer's preferences for other types of qualified pension plans.

Minimum Funding Credit Balances

The Administration proposes that the minimum required contribution to the plan for the year would be equal to the sum of the applicable normal cost for the year and eliminates the alternative minimum funding standards. SHRM supports employer flexibility to assist in the management and administration of pension plans and would therefore encourage policies that would permit credit balances. Furthermore, the elimination of the alternative funding standards limits funding flexibility as well as the need for a funding standard account. Although making larger than required contributions would not directly reduce a sponsor's future minimum funding requirements, SHRM believes the additional contributions could accelerate the date when the plan's assets reach its funding target (eliminating the need for amortization payments), reduce the amount of otherwise required new amortization payments, remove certain restrictions on plan benefits, and reduce PBGC premiums.

Tax Deductible Contribution Limits

The Administration proposes to permit funding on a tax deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year. SHRM supports the Administration's proposal to increase the spread between the minimum funding target and the maximum tax-deductible level. This approach provides a way for organizations to stabilize contributions from year to year. SHRM also suggests that considerations be made to allow limited access for post-retirement medical benefits under IRC Section 420. SHRM believes this option would increase an employer's flexibility in providing post-retirement benefits.

Phased Retirement

Although not addressed in the Administration's proposal, SHRM believes Congress should create a formal phased retirement structure in order to assist employers in workforce replacement challenges anticipated as a result of the impending retirement of the baby boom generation. A nontraditional work schedule with retirement flexibility—phased retirement—will be a key workplace issue in the 21st century.

Contributions During Economic Prosperity

The Administration's proposal strives to provide employers with additional flexibility while meeting the plans financial obligations. SHRM believes organizations should be permitted to make additional contributions during times of economic prosperity. Providing this option for employers sets an example for "planned responsible saving" and provides organizations with additional flexibility during times of unforeseen economic downturn.

SHRM supports Administration and Congressional efforts to encourage continued and new participation in the defined benefit system as well as measures to ensure that plans fully meet their funding obligations. SHRM especially appreciates the Administration's proposal to simplify the current funding rules by essentially establishing one set of required calculations.

SHRM believes that government shares responsibility with Americans to achieve adequate retirement income, and encourages Congress to continue supporting a voluntary employer-provided retirement system for employees. We look forward to working with you in the months ahead to develop a long-term solution that will ensure the integrity of the DB pension system and the solvency of the PBGC. Thank you.

Respectfully,

Susan R. Meisinger,
President and Chief Executive Officer

Statement of Alan Reuther, International Union, United Automobile, Aerospace & Agricultural Implement Workers of America

Introduction

This testimony is submitted on behalf of the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, (UAW), in connection with the hearing scheduled for March 8, 2005 by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on the subject of the President's Proposal for Single-Employer Pension Funding Reform.

The UAW represents 1,150,000 active and retired employees in the automobile, aerospace, agricultural implement and other industries. Most of our active and retired members are covered under negotiated single employer defined benefit pension plans (hereafter referred to as "pension plans".

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

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

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

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

I. Strengthening the Funding of Pension Plans

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

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

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

A). Interest Rate Assumption

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

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

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

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

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

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

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

B). Improving Plan Funding

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

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

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

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

C). Credit Balances

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

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

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

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

D). Limits on Benefits

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

The UAW is also outraged by the Administration's radical proposal to *prohibit* pension plans from even offering plant-closing benefits. These types of benefits have been an important means of cushioning the economic impact of plant closings as companies struggle to reorganize. By making it possible for more workers to retire with an adequate income, these benefits reduce the number of workers who have to be laid off and wind up drawing unemployment insurance and retraining benefits. It makes no sense, therefore, to prohibit plans from even offering this type of benefit.

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

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

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

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

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

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

E). Cash Balance Plans

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

Unfortunately, the continuing legal uncertainty concerning cash balance plans is causing some employers to shift to defined contribution plans or not to offer any pension plan at all. This was vividly demonstrated by the recent announcement by IBM that it would only provide a defined contribution plan for future employees. This trend is disturbing, both because it is bad for the future retirement income security of workers and retirees, and because it could further undermine the premium base for the PBGC.

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

II. Pension Benefit Guaranty Corporation (PBGC)

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

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

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

A). Premium Increases

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

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

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

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

B). PBGC Guarantees

The UAW opposes the Administration's proposals to cut the PBGC guarantees. These include freezing the guarantees when an employer files for Chapter 11 bankruptcy, and effectively eliminating any guarantee for plant closing benefits. These changes would unfairly punish tens of thousands of workers and retirees, reducing their retirement benefits and leaving them with a sharply reduced standard of living.

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

C). PBGC Lien for Unpaid Contributions

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

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

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

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

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

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

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

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

D). A Positive Approach to Strengthening the PGGC

Instead of the harmful, counterproductive proposals advanced by the Administration, the UAW believes that the PBGC can be strengthened through a number of approaches that would protect the interests of workers and retirees, employers and the entire defined benefit pension system.

First, the UAW believes that the overall funding of pension plans can be strengthened through the reforms we have previously supported in Section I of this testimony. By taking steps now to improve the funding of pension plans, Congress can improve the security of benefits for workers and retirees, and also reduce the long-term exposure of the PBGC. These reforms can also encourage employers to continue defined benefit pension plans, while avoiding counterproductive burdens on employers who are experiencing economic difficulties.

Second, the UAW believes that the plan reorganization process discussed previously in Section I of this testimony can be especially helpful in reducing the number of bankruptcy cases that lead to pension plan terminations and liabilities being transferred to the PBGC. In particular, we believe this type of process could be important immediately in providing the flexibility necessary for United and other airlines to continue their pension plans, instead of terminating them. This would significantly reduce the PBGC's deficit, by keeping these airline pension liabilities from being transferred to the PBGC. It would also benefit the workers and retirees at these airline companies, by keeping their pension plans going and allowing them to receive greater benefits than they would if the plans were terminated. At the same time, this reorganization process could provide significant economic relief to the troubled airlines, while still requiring them to continue some level of pension contributions. The same combination of factors could also make this type of reorganization process helpful in other industries, thereby reducing the PBGC's future exposure for pension liabilities.

Third, the UAW believes that the best way to deal with the steel and airline pension liabilities that have already or will soon be assumed by the PBGC is to have the federal government finance these liabilities over a thirty year period. This could be accomplished by having the federal government (or the PBGC) issue thirty-year bonds, and then have the federal government pay the interest on these bonds as it comes due. We believe this approach would cost the federal government about $1–2 billion per year, depending on the magnitude of the airline pension liabilities that are ultimately assumed by the PBGC.

The UAW recognizes that the federal government is already running substantial budget deficits. But this infusion of federal funds to strengthen the PBGC can easily be afforded by our nation. For example, in its current budget, the Administration has proposed significant increases in the amounts that individuals can contribute to various individual retirement and savings accounts (so-called RSAs and LSAs). This involves a substantial tax expenditure that will flow overwhelmingly to upper income individuals. The Congressional Research Service has estimated that this proposal will cost the equivalent today of $300 to $500 billion over ten years. The UAW submits that these funds could better be used to strengthen the PBGC and protect the retirement benefits of average working families in defined benefit pension plans.

Whatever the difficulties, the fact remains that using general revenues to gradually finance the PBGC's steel and airline related pension deficit is better than all of the other options currently being considered. Specifically, it is better than punishing workers and retirees by cutting the PBGC guarantees. It is better than punishing companies that sponsor pension plans by drastically increasing their PBGC premiums. And it is better than punishing companies that are experiencing financial distress by giving the PBGC a greater claim in bankruptcy proceedings. These other options will inevitably hurt workers and retirees and employers that sponsor pension plans. They will also lead to more bankruptcies and job loss. And they will drive employers away from the defined benefit pension system, creating a death spiral for the PBGC.

The truth is the PBGC was never designed to handle widespread bankruptcies and pension plan terminations across entire industries, as we have seen in steel and are now witnessing in airlines. Indeed, the seminal case that led to the creation of the PBGC was the Studebaker situation, in which a single auto company went out of business and terminated its pension plan. Obviously, the entire auto industry did not go bankrupt or terminate its pension plans then.

When the PBGC was created by Congress, it was modeled after the Federal Deposit Insurance Corporation (FDIC), which insures bank deposits for individuals. The FDIC was designed to handle isolated bank failures, not the collapse of a broad section of the banking industry. When the savings and loan crisis occurred in the 1980s, Congress wisely recognized that the costs associated with S & L failures should not be shifted onto the backs of individual depositors, nor onto the backs of other banking institutions. Congress recognized that those alternatives would impose unacceptable hardships on individuals and other banks, and would have a counterproductive impact on the rest of the banking system and our entire economy. As a result, Congress decided to have the federal government finance the S & L liabilities over many years, at a cost of hundreds of billions of dollars.

The same principles make sense in the case of the steel and airline pension liabilities that have or will be assumed by the PBGC. Shifting those costs onto workers and retirees or employers that sponsor pension plans would simply lead to unacceptable hardships and counterproductive economic consequences. The best approach—for workers and retirees, for employers that sponsor pension plans, for troubled companies and for our entire economy—is to spread those costs gradually and broadly across society by having the federal government finance them over thirty years.

This approach would not reward "bad actors". The steel and airline bankruptcies and pension plan terminations were caused by many factors, including the policies (or non-policies) of the federal government relating to trade, deregulation, energy and health care, as well as the shocks flowing from the terrorist attacks on September 11th. In our judgment, it is entirely appropriate to now ask the federal government to help pay for the pension costs flowing from those policies and events.

Indeed, Congress already endorsed this notion in a more limited context. In the Trade Act of 2002, Congress provided for a new 65 percent tax credit to pay for retiree health benefits for retirees whose pension plans have been terminated and taken over by the PBGC, and who are between the ages of 55–65. Through this provision, Congress effectively used general revenues to pay for part of the costs associated with providing retiree health benefits to this group of retirees. This provision was designed primarily as a response to the bankruptcies (and pension plan terminations) in the steel industry, which had resulted in thousands of steelworker retirees losing their health benefits. It reflected a recognition by Congress that our trade and health care policies had played a role in the steel company bankruptcies and the loss of retiree health benefits. The UAW submits that the same principles now justify using general revenues to pay for the pension costs flowing from the steel and airline bankruptcies and plan terminations.

Similarly, Congress has a long history of using general revenues to respond to disasters across our nation. This includes floods, hurricanes, droughts and many other types of catastrophes. The UAW submits that the devastation that has occurred in our steel and airlines industries is no less worthy of federal assistance.

There is no danger this type of approach will create a "moral hazard" leading to worse pension funding and more problems in the future. This is because the UAW is proposing that the infusion of general revenues to pay for the airline and steel pension liabilities be coupled with the package of reforms to strengthen the funding of other pension plans and with the new plan reorganization process that will help troubled companies to continue their pension plans and reduce the future exposure of the PBGC.

Conclusion

The UAW appreciates this opportunity to submit testimony to the Committee on Ways and Means to express our views on the President's proposal for single-employer pension funding reform. We urge the Committee to reject the Administration's harmful and counterproductive proposals, and instead to fashion a constructive package that will strengthen the funding of pension plans, protect workers and retirees, provide stability and predictability to employers that sponsor pension plans and encourage them to remain in the defined benefit pension system, and place the PBGC on a sound and sustainable path.

We look forward to working with Members of the Committee on Ways and Means as you consider these important pension issues. Thank you.