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S. HRG. 109–165

A PENSION DOUBLE HEADER: REFORMING HYBRID AND MULTI-EMPLOYER PENSION PLANS

HEARING

BEFORE THE

SUBCOMMITTEE ON RETIREMENT SECURITY AND AGING

OF THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINING REFORMING HYBRID AND MULTI-EMPLOYER PENSION PLANS, FOCUSING ON THE CAUSES OF UNCERTAINTY FOR HYBRIDS AND MULTI-EMPLOYER PLANS, INCLUDING FUNDING PROBLEMS AND PROPOSALS TO RESTORE STABILITY AND SOLVENCY

JUNE 7, 2005

Printed for the use of the Committee on Health, Education, Labor, and Pensions

U.S. GOVERNMENT PRINTING OFFICE

21–771 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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A PENSION DOUBLE HEADER: REFORMING HYBRID AND MULTI-EMPLOYER PENSION PLANS

TUESDAY, JUNE 7, 2005

U.S. SENATE,
SUBCOMMITTEE ON RETIREMENT SECURITY AND AGING,
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:06 a.m., in Room 430, Dirksen Senate Office Building, Hon. Mike DeWine, chairman of the subcommittee, presiding.

Present: Senators DeWine, Enzi, Isakson, Kennedy, Harkin and Mikulski.

OPENING STATEMENT OF SENATOR DEWINE

Senator DEWINE. Good morning. Welcome all of you. I call to order this hearing of the Subcommittee on Retirement Security and Aging.

I would like to take this opportunity to express my strong support for hybrid pension plans and for multi-employer plans. Both types of plans provide valuable retirement security for millions of American workers. Both plans, however, are in trouble.

This hearing will explore the causes of uncertainty for hybrids and multi-employer plans. For hybrids it is conflicting legal opinion. For multi-employer plans the problem is financial uncertainty. We must find ways to clear barriers out of the way so the plans can in fact survive.

I am encouraged by the proposals that are being offered to address the legal and the economic problems of these plans. At the first hearing of this subcommittee in April, in talking about the current crisis in the private pension system, I said that a taxpayer bailout is really just not an option.

The witnesses at today's hearing are not coming here hat in hand. Rather, they are presenting real life concerns and offering real world solutions. In the case of the multi-employer plans today's witnesses are united, united in their commitment to getting the financial affairs in order without a taxpayer bailout.

Let me at this point, before I introduce the panels, turn to my partner in this endeavor, my friend who has worked with me on so many other issues, Senator Mikulski.

OPENING STATEMENT OF SENATOR MIKULSKI

Senator MIKULSKI. Good morning. Mr. Chairman, I want to thank you for convening this very crucial panel, and I pledge to you a bipartisan effort to come to grips with these issues. These issues, the pensions that people rely upon, the pension guarantee that we need to ensure stability of funding, is too important to be engaged in politics.

America is facing a challenge. Corporations are challenged to fulfill their pension responsibilities, and that means America is also facing challenges.

We both come from a manufacturing base and we know how challenged many of those are, and we also know how challenged the defined benefit plans are. We know that there have been transitions. We know the multi-employer plans have challenges also.

We have to make sure we listen to business and to workers and protect these pensions without forcing a one-size-fits-all solution and to protect all the workers while pensions are changing. Many people are losing their sleep over the pension issue. It has a tremendous impact on employees and retirees and on productivity, especially those who experience reduction in their pensions or fear that they will be reduced or eliminated.

We also need to work with the private sector to protect the good guy businesses who still want to offer pensions to their employees and to their retirees.

I know we are going to focus in this first panel on the multi-employer pension plans, and we talked about that at the pension benefit guaranty corporation hearing we had last month. We know that now we are looking at 25 percent of the PBGC fund to cover multi-employer plans, everything from grocery clerks to people in the building trades. We have to take a look at how we reform, but that in an over-exuberance of reform we do not have unintended negative consequences.

The cash balance plans provide an even bigger challenge on how we can get ourselves ready for the innovation economy, and understand the portability and mobility of younger workers, but not discriminate those people who built America's companies, and made them great. We need to make sure that plans are protected in this transition from a manufacturing economy to a more innovation economy.

Again I look forward to listening to our witnesses, learning from our witnesses, and working with you on a bipartisan basis.

[The prepared statement of Senator Mikulski follows:]

PREPARED STATEMENT OF SENATOR MIKULSKI

Introduction

Mr. Chairman, I want to thank you for this important hearing. America is facing a challenge. Corporations are unable to fulfill their pension responsibilities. That means American workers are facing a challenge. That's why I want to work with my colleagues in the Senate to help save pension plans that are in trouble. Though today we are talking specifically about Cash Balance and Multi-Employer pension plans. This is part of the larger discussion on how to protect the retirement of America's workers.

Retirement Security

Retirement security is one of the most important issues we face today. Everyone wants to retire with dignity and financial security, yet, every day I pick up the paper and see another article on our pension system in crisis. From the United Airlines bankruptcy settlement, to the PBGC funding shortfall, we have a real problem on our hands!

Indeed, many people are losing sleep over this. The morale of both employees and retirees is suffering. Especially those who have experienced reductions in their pension benefits.

Promises made must be promises kept but that isn't easy given these difficult economic times. We in Congress must work to protect both "good guy" businesses who still offer pensions to their employees and the retirees who rely so heavily on their pensions. Though we must protect the older worker while pension funds are changing we must keep in mind that "one size does not fit all." For example, we must remember, young workers like cash balance plans, so any solution we design to protect our older workers must "do no harm" to younger workers as well.

Conclusion

Though pension funding is not yet in crisis, we need to take steps now to prevent our companies from true crisis, our workers from true crisis, and shore up the solvency of pension plans. It is clear that pension reform is needed. I welcome and look forward to hearing from our witnesses today.

Senator DEWINE. Senator, thank you very much.

Senator DEWINE. Today we are going to hear from two panels of extremely qualified witnesses. The first panel will focus on the funding problems of the multi-employer pension plans, and the legislative proposals designed to restore stability and solvency.

First to speak will be Randy DeFrehn. Mr. DeFrehn, thank you very much for joining us today.

He is the Executive Director of the National Coordinating Committee for Multi-Employer Plans. Mr. DeFrehn is perhaps the most knowledgeable person on the extremely complicated issues of multi-employer plans, and we look forward to his clear and concise presentation.

Following his testimony, the next witness will be Mr. Tim Lynch, who is the President and CEO of the Motor Freight Carriers Association. He will testify to the current funding crisis, discuss proposals being offered by a broad coalition of management and union groups.

Next we will hear from Mr. Jeffrey Noddle, Chairman of the Board, President and CEO of SUPERVALU, America's largest food wholesaler and seventh largest grocery retailer. In Ohio of course we know their good work. Senator Mikulski, no doubt, has had the occasion to shop at Shoppers Food Warehouse and other places. We look to hearing from Mr. Noddle about the views of the Food Marketing Institute and how they would have us reform the law on multi-employer plans.

Closing out the first panel will be Mr. John Ward, President of Standard Forwarding Company, a trucking firm based in East Moline, IL. His firm is perhaps the exception, a growing trucking com-

pany that is adding new active participants to the Teamsters Central States Pension Plan. He will express his concerns about some of the proposed multi-employer reforms and how they impact small firms. Mr. Ward is appearing on behalf of the Multi-Employer Pension Plan Alliance.

The second panel will discuss the important issue of hybrid pension plans. These most typically are cash balance plans or pension equity plans.

The first witness we will hear from will be William Sweetnam, an attorney with the Groom Law Group in Washington, DC. Mr. Sweetnam will be delivering the testimony of James Delaplane, who was supposed to appear today but was called out of town for a family emergency. Both Mr. Sweetnam and Mr. Delaplane represent the American Benefits Council. It is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers in providing benefits to employees.

We will also hear from Ellen Collier, Director of Benefits at the Eaton Corporation in Cleveland. Her company, a diversified industrial manufacturer with over 27,000 employees in 100 locations in the United States, converted to a hybrid pension plan design. She will describe the process and care with which the company undertook such a change.

Finally, we are pleased to have as a witness, David Certner, Director of Federal Affairs for AARP. Mr. Certner is well known to the members of this committee, and we once again appreciate his willingness to testify.

Let me just make a final comment before we begin the testimony. I want to point out that it is my understanding that Chairman Enzi, chairman of the full committee, intends to move a comprehensive reform bill out of the full HELP Committee this summer, sometime before the August recess. Meeting that schedule is certainly going to take a lot of hard work and a high degree of bipartisan cooperation. The hearing today is testimony I think really to the willingness of Republicans and Democrats to work together to solve our country's pension problems. Both sides want to get these issues out in the open, and we want to get them resolved and resolved as quickly as possible.

So let me at this point turn to our witnesses. Mr. DeFrehn, we will start with you. We are going to have 5 minute rounds and we are going to ask you to keep your statements to 5 minutes. We have your written testimony in front of us, and if we could have everyone follow the 5 minute rule, then we will have ample time for questions.

Thank you very much.

STATEMENTS OF TIMOTHY P. LYNCH, PRESIDENT AND CEO, MOTOR FREIGHT CARRIERS ASSOCIATION, WASHINGTON, DC; RANDY G. DeFREHN, EXECUTIVE DIRECTOR, NATIONAL COORDINATING COMMITTEE FOR MULTI-EMPLOYER PLANS, WASHINGTON, DC; JEFFREY NODDLE, CHAIRMAN OF THE BOARD, PRESIDENT AND CEO, SUPERVALU, INC., ON BEHALF OF THE FOOD MARKETING INSTITUTE; AND JOHN WARD, PRESIDENT, STANDARD FORWARDING COMPANY, EAST MOLINE, IL, ON BEHALF OF THE MULTI-EMPLOYER PENSION PLAN ALLIANCE

Mr. DEFREHN. Thank you, Senator. If I might ask your indulgence though, if it would be all right for Mr. Lynch to lead off, and then I will follow his comments.

Senator DEWINE. You can do that if that is all right with Mr. Lynch.

[Laughter.]

Senator DEWINE. Is that all right with you, Mr. Lynch?

Mr. LYNCH. It is now.

[Laughter.]

Mr. LYNCH. Thank you, Mr. Chairman and Senator Mikulski for having this hearing.

I am here today as a representative of trucking industry employers, who by virtue of their collective bargaining agreement are major participants in a number of multi-employer pension plans.

In addition, I was a participant in discussions that began last October with other industry and labor representatives, resulting in a coalition proposal that we believe addresses many of the problems facing multi-employer plans.

In my written statement I have provided the subcommittee with information about recent trends in the trucking industry and the relationship between our collective bargaining agreement and the pension funds that I would like to submit for the record.

For my oral testimony I would like to focus on a process by which we arrived at our recommendations and then summarize those recommendations. The coalition proposal represents what I believe is a unique opportunity in that it is the only reform proposal that has the full support of contributing employers, organized labor and those responsible for the governance, administration of multi-employer plans, in other words, all of the parties most directly affected by the MEPA statute. I would respectfully suggest that the effort to bring all those diverse interests to common ground is worthy of serious congressional consideration.

When we began our discussions last October, not surprisingly, the employer representatives were intent on protecting the economic interests of the contributing employers. Similarly, the union representatives were intent on protecting the benefits of retirees and the future benefits of the active employees.

The underlying equation of multi-employer plans is that new employers will replace exiting employers, thus maintaining a balance of contributing employers. Unfortunately, for plans in the trucking industry, generally referred to as mature plans, that equation is seriously out of balance with many more bankruptcies than new entering employers. There are only so many avenues to pursue to improve the financial condition of these plans, more contributing em-

ployers, more contributions from current employers, benefit modifications, better investment returns or some form of Government assistance.

Our working group quickly concluded that Government assistance was unlikely, an increase in the number of contributing employers doubtful, and better investment returns, while hopefully on the horizon, are nonetheless speculative. That left additional contributions and benefit modifications. It is to the credit of those in the working group and the interests that they represent that we all recognize the risk and concern attendant to both additional contributions and benefit modifications.

Any significant increases in employer contributions run the very real risk of jeopardizing the large pool of small employers typically involved in multi-employer plans. Conversely, any significant modifications in the benefit plan raises significant issues of labor/management relations, and frankly, issues of fundamental fairness with retirees.

Had I written this proposal myself or in concern with other contributing employer representatives, it would look very different. I feel confident that the same holds true for our union counterparts. But had we abandoned our joint efforts and gone our separate ways we very well could have won the rhetorical battle but lost the substantive war. We chose to compromise and present a package of recommendations that we believe will address the problems. With that as background, I would like to summarize the main features of our proposal.

First, because of the diversity of multi-employer plans we concluded that a one-size-fits-all approach would not be beneficial. Consequently, our proposal categorizes plans as healthy, at-risk and severely underfunded, and targets remedial programs to fit plans in those categories.

Second, unlike single-employer plans, multi-employer plans function as a quasi PBGC with contributing employers assuming plan liabilities and shielding the Federal agency from that responsibility, literally to the last-man-standing principle. Unfortunately, most of the tools available to address funding problems are not available to the plan trustees or are viewed as last resort remedies by Federal agencies. The coalition proposal gives additional tools to the trustees to address short term funding problems as well as the long term objective to balance plan assets and liabilities.

Third, all parties to the plans deserve more timely and meaningful disclosure of information about the status of the plans and the coalition proposal does that. Additionally, the proposal establishes an early warning system for those at risk plans. Under our proposal the most difficult and controversial remedies, additional employer contributions and benefit modifications, are reserved for those plans that face the most severely underfunded problems. This is in part designed as a strong incentive to plan trustees to do all they can to solve the problems before entering what we call the "Red Zone."

Finally, with respect to withdrawal liability for the remaining contributing employers in the trucking industry, this is the proverbial between a rock and a hard place issue. These employers have

no ability to control the extent of their potential liability when other contributing employers withdraw from the plan.

I have about 20 seconds?

Senator DEWINE. That will be fine.

Mr. LYNCH. Thank you. Withdrawal liability was intended to address that problem. However, that has not been the case. From a public policy perspective it is difficult to justify a denial or reduction of benefits to these nonsponsored participants. However, if that remains Government policy, it is equally difficult to justify allowing withdrawing employers to fully escape or significantly limit their liability responsibilities.

The coalition proposals attempts to strengthen and clarify withdrawal liability rules to protect the remaining contributing employers from assuming a disproportionate and unfair burden from nonsponsored participants.

Thank you.

Senator DEWINE. Good. Thank you very much.

[The prepared statement of Mr. Lynch follows:]

PREPARED STATEMENT OF TIMOTHY P. LYNCH

Mr. Chairman and members of the committee, good morning. My name is Timothy Lynch and I am the President and CEO of the Motor Freight Carriers Association (MFCA). I want to begin by thanking Chairman DeWine and the other members of the Subcommittee on Retirement Security and Aging for holding this hearing to discuss suggestions for securing the long term viability of the multi-employer pension system.

I am here today as a representative of an association of trucking industry employers who by virtue of their collective bargaining agreement are major participants in a number of multi-employer plans. Their companies are key stakeholders in these funds. The employers I represent are concerned about the current framework for multi-employer plans and strongly believe that if not properly addressed, the problems will increase and possibly jeopardize the ability of contributing employers to finance the pension plans. The end result could put at risk the pension benefits of their employees and retirees.

While we were supportive of Congressional efforts last year to address short term relief for multi-employer plans under the Pension Funding Stability Act, we believed then, and continue to hold the view, that significant reform needs to occur if we are to secure the long term viability of these plans. The financial difficulties facing the Central States pension fund are well known to this committee, but Central States is not alone. Nor are the factors contributing to the problems of Central States unique. The challenges facing these pension funds need immediate attention.

In my testimony today, I will outline a series of recommendations that are the result of many months of discussion and negotiation among the parties most directly affected by the MPPAA statute. These recommendations represent a unique opportunity in that they are the only reform proposal that has the full support of contributing employers, organized labor, and those responsible for the governance and administration of multi-employer plans. I would respectfully suggest that the effort to bring all these diverse interests to common ground is worthy of Congressional consideration.

MOTOR FREIGHT CARRIERS ASSOCIATION

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

Through its TMI Division, MFCA was the bargaining agent for its member companies in contract negotiations with the Teamsters for the current National Master Freight Agreement (April 1, 2003—March 31, 2008). Under that agreement, MFCA member companies will make contributions on behalf of their Teamster-represented employees to 90 different health & welfare and pension funds. At the conclusion of

the agreement, MFCA companies will be contributing $12.39 per hour per employee for combined health and pension benefits, or a 33 percent increase in benefit contributions from the previous contract. This is in addition to an annual wage increase.

DESCRIPTION OF PLANS

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

As Taft-Hartley plans, these pension funds are jointly-trusteed (an equal number of labor and management trustees) and provide a defined benefit (although some plans offer a hybrid defined benefit/defined contribution program). MFCA member companies are represented as management trustees on most of the plans to which they make contributions. In an effort to help improve the management of the plans, MFCA member companies have made a concerted effort to nominate as management trustees individuals with backgrounds in finance, human resources, and employee benefits.

RELATIONSHIP BETWEEN COLLECTIVE BARGAINING AND THE PENSION PLANS

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

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

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

As noted earlier, employers' role with respect to multi-employer pension plans is limited to making contributions unless the plan runs into financial difficulty. Under current law, employers are ultimately responsible for any funding deficiency that the multi-employer plan may encounter. Specifically, if a multi-employer plan hits a certain actuarially calculated minimum funding level, employers in the fund are assessed a 5 percent excise tax and their pro-rata share of the funding shortfall or face a 100 percent excise tax on the deficiency.

HOW WE GOT TO WHERE WE ARE

1980 was a watershed year in the history of the trucking industry. In that year Congress passed two major legislative initiatives—the Motor Carrier Act (MCA) and the Multi-Employer Pension Plan Amendments Act (MPPAA)—that radically altered the profile of the industry and the landscape for industry sponsored pension plans. The first brought about deregulation of the trucking industry and ushered in an era of unprecedented market competition. The second, while perhaps not recognized at the time, upset the essential balance between exiting and entering employers that is key to maintaining a viable multi-employer pension program.

To put this in some perspective, I have included in my statement (Appendix A), a list of the top 50 general freight, LTL carriers who were operating in 1979, the year just prior to enactment of MCA and MPPAA. Of those 50, only 7 are still in operation and of those 7 only 5 are unionized. Virtually all of the 43 truck companies no longer in business had unionized operations, and consequently were contributing employers to industry sponsored pension plans. There have been no subsequent new contributing employers of similar size to replace these departed companies. And beyond the top 50 there were literally hundreds, perhaps thousands, of smaller unionized truck operators who also have fallen by the wayside. The simple fact is that since 1980 there has not been a single trucking company of any significant size to replace any of the departed companies on the Top 50 list.

And what happens when these companies leave the plans? Their employees and retirees become the responsibility—not of the PBGC—but of the plans and their remaining contributing employers. In short, the remaining contributing employers function as a quasi-PBGC ensuring the full pension benefit.

One of the key elements of the MPPAA statute was the ability to recover assets from withdrawing employers or withdrawal liability. Unfortunately, that has not been the case. One of the largest trucking industry plans reports that bankrupt (withdrawing) employers ultimately pay less than 15 percent of their unfunded liability. And what happens when these liabilities are not fully recovered? They become the responsibility of the remaining contributing employers. This represents one of major differences between the treatment of liabilities of single versus multi-employer pension plans.

Nothing highlights the inequity of this situation more than the bankruptcies of two contributing employers: Consolidated Freightways (CF) and Fleming Companies. Both companies were in the top 10 category of contributing employers to the Central States plan. They also sponsored their own company, single-employer plan for their non collective bargaining covered employees. The PBGC has assumed responsibility for the CF plan with a potential liability in excess of $250 million and the Fleming plan with a projected liability in excess of $350 million or a combined liability for PBGC of over $600 million.

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

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

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

RECOMMENDATIONS FOR LEGISLATIVE ACTION

Last October, we began participating in a small working group of trucking company and union representatives to try to develop recommendations that would be acceptable to multi-employer plans, unions and contributing employers. The objective was to develop a legislative proposal that would alleviate the short-term consequences of funding deficits and promote long-term funding reform for multi-employer plans. As a representative of contributing employers, I entered those discussions with a clear mission to protect the economic interests of my membership. My union counterparts entered with a similar mission to protect the interests of their membership.

Early on in those discussions, we agreed on several fundamental issues that ultimately formed the basis for our recommendations.

• Because of the diversity of multi-employer plans, a one-size-fits-all approach would not be productive. Instead remedial programs would be targeted to those plans facing the greatest financial problems.

• Multi-employer plans function as a quasi-PBGC, with contributing employers assuming plan liabilities and shielding the Federal agency from that responsibility until plan bankruptcy. Unfortunately, plan trustees don't have all the tools available to the PBGC to address funding problems.

• Furthermore, most of the tools available to address funding problems become available too late in the process and are often viewed as "last-resort" remedies by Federal agencies.

• All parties to the plans deserve more timely and meaningful disclosure of information about the status of the plans.

• The need to establish an early warning system for "at risk" plans and a separate category for "severely underfunded" plans.

• The burden to fix the problem of severely underfunded plans should not be borne disproportionately by any one party to the plans. To do otherwise would, in fact, jeopardize the continued viability of the plan and its defined benefits.

This process ultimately was expanded to include employer and union representatives from other industries. The result is a coalition proposal that has the support of a wide range of business and labor organization interests.

From the contributing employer perspective, the key elements of the coalition proposal are the following.

FUNDING RULES

Under the proposal, multi-employer plans will be required to have strong funding discipline by accelerating the amortization periods, implementing funding targets for severely underfunded plans and involving the bargaining parties in establishing funding that will improve plan performance over a fixed period of time. In addition, the proposal limits the ability for plan benefit enhancements unless the plan reaches certain funding levels.

FUNDING VOLATILITY

By virtue of their collective bargaining agreements, contributing employers must make consistent payments regardless what gains are achieved in the financial markets. (This is in contrast to single-employer plans that may avoid contribution payments in lieu of above average market returns). However, the volatility of these plans occurs in the form of funding deficiencies. The coalition proposal addresses this situation by allowing the plans to use existing extension and deferral methods to permit time for the bargaining process to address the underfunding over a rational period of time.

EARLIER WARNING SYSTEM

The coalition proposal establishes a "yellow zone" or early warning system. The goal of the yellow zone concept is to make sure plans are cautious in the ability to have affordable benefit levels. Additionally, plans in the yellow zone must improve their funded status in a responsible manner, one that does not put extreme pressure on the benefits provided or eliminate the ability for employers to operate in a highly competitive marketplace. The coalition proposal strikes a reasonable balance through creation of a bright line standard for an improving funded status but not one that creates an insurmountable and unreasonable financial burden on contributing employers. While it is important that yellow zone plans develop a program for funding improvement, the burden to do so should be commensurate with the ability to recover over a rational period of time.

PLANS WITH SEVERE FUNDING PROBLEMS

Under the coalition proposal, plans facing severe funding problems are in a "red zone" or essentially reorganization status. When a plan is in reorganization status, extraordinary measures will be necessary to address the funding difficulties. It is here that the concept of shared responsibility for balancing plan assets and liabilities fully comes into play. Reorganization contemplates a combination of contribution increases—above those required under the collective bargaining agreement—and benefit reductions—though benefits at normal retirement age are fully protected—to achieve balance.

TRANSPARENCY AND DISCLOSURE

The Pension Funding Stability Act of 2004 greatly improved the transparency of multi-employer plans. The coalition proposal expands those disclosures and places additional disclosure requirements for plans that are severely underfunded in the red zone.

WITHDRAWAL LIABILITY

For the remaining contributing employers in the trucking industry, this is the proverbial "between a rock and a hard place" issue. These employers have no ability to control the extent of their potential liability when other contributing employers withdraw from the plan. Withdrawal liability was intended to address that problem. However, as I indicated earlier, one large trucking industry plan estimates it recovers on average less than 15 percent of assets required to cover the benefit liabilities. Non-sponsored participants now make up 50 percent of the benefit pool in Central States.

From a public policy perspective, it is difficult to justify a denial or reduction of benefits to these non-sponsored participants. However, if that remains Government policy it is equally difficult to justify allowing withdrawing employers to fully escape or significantly limit their liability responsibilities. The coalition proposal attempts to strengthen and clarify withdrawal liability rules to protect the remaining contributing employers from assuming a disproportionate and unfair burden from non-sponsored participants.

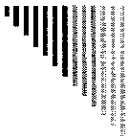
Mr. Chairman, thank you for giving me the opportunity to present the views of the Motor Freight Carriers Association. I look forward to working with the members and staff of this committee to develop a long term solution to the problems facing multi-employer pension plans. I would be happy to answer any questions you may have.

TOP 50 LTL CARRIERS IN 1979

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

Bold = Still Operating on 4/1/04

[Exhibit 1 can be found in committee files.]

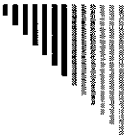


Many Large Funds Faced Significant Underfunding in 2002

Plan Name	Liabilities (millions)	Shortfall (millions)	Percent Funded
Western	28,523.0	(3,214.7)	92%
Central States	30,978.5	(10,211.7)	64%
New York State	2,931.4	(837.6)	76%
Central Pa.	820.9	(216.5)	68%
Phila. & Vicinity	2,210.1	(962.1)	53%
Western Pa.	1,407.7	(320.1)	72%
Local 705	1,539.9	(425.8)	70%

Note: All figures are in millions and are for 2002.

Exhibit 2

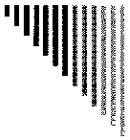


Participant Ratios Suggest Future Funding Challenges

Plan Name	Active Employees / Beneficiaries	Active Employees / Total Participants
Western	2.60	0.96
Central States	0.87	0.63
New York State	1.11	0.86
Central Pa.	0.62	0.44
Phila. & Vicinity	0.81	0.61
Western Pa.	0.59	0.42
Local 705	0.79	0.61

Note: All figures are for 2002.

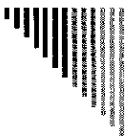
Exhibit 3



Financial Status Continues to Deteriorate

- Underfunding in 2004 continues to climb
  - Central States – $11.2 billion
  - New England – $945 million
- Participant ratios continue to deteriorate
  - Central States
    - 2002 – 87%
    - 2004 – 74%

Exhibit 4



Central States Pension Plan: Active Participants and Beneficiaries Comparison

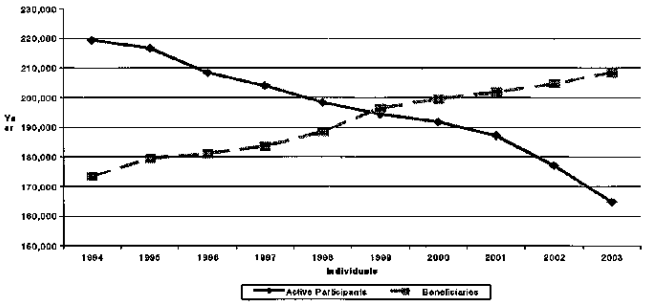
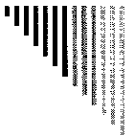


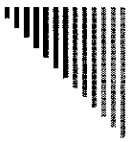
Exhibit 5



What happens in the event of a funding deficiency?

- ERISA requires employers to make up the deficit. This is in addition to normal contributions.
- In 1st year, we must pay to the IRS a 5% excise tax.
- In 2nd year, if all employers do not make required payments, then we must pay to the IRS a 100% excise tax.

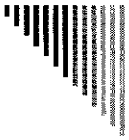
Exhibit 6



EXAMPLE: Company with 100 Employees in Plan:
Contribution Rate = $89.00 per week

Contributions Last Year / Total Contributions Last Year	X	$ Deficiency	=	Our Share
1st Year:				
$462,800 / $1,000,000,000	X	$393,000,000	=	$181,880
		+5%	=	9,094
		Total	=	$190,974
2nd Year:				
$462,800 / $1,000,000,000	X	$1,346,000,000	=	$622,929
		+5%	=	31,143
		+100%	=	181,880
		Total	=	$835,952
3rd Year:				
$462,800 / $900,000,000	X	$2,536,000,000	=	$1,304,067
		+5%	=	65,203
		+100%	=	622,929
		Total	=	$1,992,199

Exhibit 7



Central States' Estimates of Deficiency:

- 2004: $0.40 per dollar of contributions
- 2005: $1.41 per dollar of contributions
- 2006: $2.73 per dollar of contributions
- 2011: $15.29 per dollar of contributions

Exhibit 8

Senator DEWINE. Are you ready, sir?

Mr. DEFREHN. Yes, I am. Thank you.

Senator DEWINE. Very good.

Mr. DEFREHN. Mr. Chairman, Senator Mikulski, thank you for inviting me to participate in today's hearing on this important topic. I appear before you on behalf of the nearly 10 million participants of multi-employer defined benefits plans, both in my capacity as Executive Director of the National Coordinating Committee for Multi-Employer Plans, and as a member of a broad based coalition of employers and employee organizations who recognize the important role such plans play in the lives of our participants, their families and the communities in which they live.

You have just heard how all of the major trucking industry employer associations, large individual employers, and the Teamsters have been full partners in the development of the coalition proposal. Given the size and complexity of their plans and the problems they currently face, it is entirely appropriate they should be fully involved. However, this represents far more than a trucking industry initiative. The coalition represents the interests of funds in virtually all aspects of the economy, including construction, service, garment, hospitality, long shore, mining, paper, chemical, aerospace and trucking industries.

The construction industry, which makes up more than half of all multi-employer plans, is the largest block of coalition members, including the Associated General Contractors, Bechtel Corporation, the Washington Group, all of the major specialty contractor associations and all 15 of the construction trade's unions. The entertainment industry is also represented by both employer and labor groups, and although FMI has expressed reservations that the coalition proposal does not go far enough for some of their members in certain areas, the major labor groups representing their employ-

ees, the United Food and Commercial Workers and the Teamsters, participate in the development of and fully endorse the proposal.

Last, two other groups not usually associated with multi-employer issues, the U.S. Chamber of Commerce and the American Benefits Council, also support the proposal.

The proposal itself embodies several important propositions. First, funding rules should be strengthened to help plans avoid problems over which they have some control. Second, plans should receive relief from situations over which they have no control. Third, the stakeholders must share the burden presented when the unavoidable occurrence threatens the long term viability of the plans. Fourth, these plans are a creation of the collective bargaining process and the process is best equipped for finding solutions acceptable to all the stakeholders. Fifth, the future of the plans will be jeopardized when active employees no longer derive any benefit from continued participation, and sixth, reduction of accrued benefits should only occur as an alternative to more significant reductions that would occur if the plans were to fail and go to the PBGC guaranty levels.

The proposal focuses on three broad areas of reform based on the relative funding health of the plans. Plans that are currently well funded are required to amortize plan improvements more quickly than under current rules. Also, tax laws that have forced the plans to increase cost to protect contributing employers' tax deductions should be changed to provide a buffer against the unexpected.

Plans that begin to see an erosion in their funded position, a funded ratio below 80 percent, must implement a benefit security plan that requires the funding level to be improved over time. Any amendment to the plan of benefits must have offsetting contribution increases that exceed the cost of that amendment.

Plans with severe funding problems would be placed in reorganization under revised rules, and the plan fiduciaries and bargaining parties would be provided with additional tools to bring the plan assets and liabilities into balance. Once in reorganization, notice would be given to all stakeholders. The employers would be subjected to all surcharges in lieu of being assessed extra contractual contributions and excise taxes. Certain restrictions would apply immediately to benefit payments that expedite the depletion of the fund. Trustees would be required to develop and distribute to all stakeholders a plan or reorganization to bring the plan out of reorganization within roughly three bargaining cycles.

Options to current benefit and contribution structures, including possible amortization extensions and mergers, but which would also include possible elimination of certain benefits that are currently protected under anti-cutback rules, would be developed by the trustees and submitted to the parties. Schedules showing the amount of benefit modifications necessary to bring the plan out of reorganization would be presented to the bargaining parties who would then bargain over the appropriate combination of modifications and contribution increases. The plan or reorganization and schedules would be revised and distributed to stakeholders at least annually.

Other provisions include withdrawal liability statutes, changes to the withdrawal liability statutes to make it more difficult for con-

tributing employers to shift their responsibility to remaining employers upon withdrawal from the fund.

Clearly the provisions in this proposal, quite different than would have been included in a document drafted independently by either employer or employee representatives, nevertheless, it represents an excellent compromise and a responsible way to address the current problems. As with any carefully negotiated compromise, however, its strength and indeed that of the coalition itself, lies in preserving the elements of the proposal as closely as possible to the original. The more changes that are introduced into the substance of the proposal, the greater the likelihood that certain groups will withdraw their support. For that reason, we recommend the document to you in its entirety, and request your help in seeing it enacted into law.

In closing, I would like to thank you for your attention and for the invitation to participate in this discussion and look forward to your questions.

Senator DEWINE. Thank you very much.

[The prepared statement of Mr. DeFrehn follows:]

PREPARED STATEMENT OF RANDY G. DEFREHN

Mr. Chairman and members of the committee, I am pleased to be here today to discuss the subject of reforming multi-employer defined benefit pension plans. I appear here on behalf of a broad coalition of plans, employers, employer associations and labor organizations that sponsor multi-employer plans which has put forth a carefully negotiated, balanced proposal for multi-employer pension plan reform. The coalition proposal has evolved through the efforts of many of the system's largest stakeholders since the Pension Funding Equity Act of 2004 failed to provide meaningful relief to even a single multi-employer plan, despite the laudable efforts of a majority of the Members of this Chamber. A list of those groups who are participants in the coalition is enclosed with my written remarks, but it is important to note that they represent the overwhelming majority of employers and virtually all of the unions in the construction, trucking, entertainment, service and food industries and the membership of the National Coordinating Committee for Multi-Employer Plans (NCCMP) which directly represents over 600 jointly managed pension, health, training and other trust funds and their sponsoring organizations across the economy. The NCCMP is a non-profit, non-partisan advocacy organization formed in 1974 to protect the interests of plans and their participants following the passage of ERISA and the increasingly complex legislative and regulatory environment that has evolved since then.

BACKGROUND

There are nearly 1,600 multi-employer defined benefit pension plans in the country today. They provide benefits to active and retired workers and their dependents and survivors in virtually every area of the economy. Because of their attractive portability features, multi-employer plans are most prevalent in industries, like construction, which are characterized by mobile workforces. According to the latest information from the Pension Benefit Guaranty Corporation, multi-employer plans cover approximately 9.7 million participants, or about one in every four Americans who still have the protection of a guaranteed income provided by a defined benefit plan. With few exceptions, these are mature plans that were created through the collective bargaining process 50 to 60 years ago and have provided secure retirement income to many times that number of participants since their inception. Although some mistakenly refer to them as "union plans" the law has required that these plans be jointly managed with equal representation by labor and management on their governing boards since the passage of the Labor Management Relations (Taft-Hartley) Act in 1947. This active participation by both management and labor representatives (most of whom are participants in the plans) provides a clear distinction between single-employer and multi-employer plans. They are more extensively regulated under both labor and employee benefits laws and regulations and the watchful eyes of the Department of Labor, the Internal Revenue Service and the Pension Benefit Guaranty Corporation. Most important among these laws and regu-

lations, Taft-Hartley requires that the fiduciaries who serve on these joint boards must manage these plans for the "sole and exclusive benefit" of plan participants, and ERISA imposes fiduciary obligations on plan fiduciaries that put at risk the personal assets of those who fail to meet their obligations.

It is estimated that there are over 65,000 employers that contribute to multi-employer plans. The vast majority of which are small employers. For example, in the construction industry, which makes up more than 50 percent of all multi-employer plans (but just over one-third of the participants), it is estimated that as many as 90 percent of all such employers employ fewer than 20 employees. By sponsoring these industry plans, employers are able to ensure that their employees have access to comprehensive health and pension benefits and, through the jointly managed training and apprenticeship plans, the employers have access to a readily available pool of highly skilled labor, none of which could be feasible for individual employers to provide.

Funding for multi-employer plans comes from the negotiated wage package agreed to in the collective bargaining process. For example, if the parties agree to an increase in the wage package of $1.00 per hour over 3 years, the $1.00 may be allocated as $.40 to the health benefit plan, $.20 to pensions, $.05 to the training fund and the remaining $.35 taken in increased wages. Although for tax purposes, contributions to employee benefit plans are considered to be employer contributions, the funding comes from monies that would otherwise be paid to the employee in the form of wages. For the overwhelming majority of such employers, their regular involvement with the plans is limited to remitting their monthly payments to the trust funds as required pursuant to their collective bargaining agreements. For most contributing employers, these funds are the perfect substitute for a large financial commitment to human resources functions, providing administrative services and meeting today's complex compliance requirements while providing economies of scale that would otherwise make such benefit plans unaffordable for small business.

Since the passage of the Multi-Employer Pension Plans Amendments Act of 1980, participants of multi-employer plans have been covered by the benefit guarantee provisions of the PBGC. Unlike single-employer plans, however, the PBGC is the insurer of last resort for multi-employer plans. Instead, the employers who contribute to these plans self-insure against the risk of failure of another. Under the multi-employer rules, employers who no longer contribute, or cease to have an obligation to contribute to the plan, must pay their proportionate share of any unfunded vested benefits that exist at the time of their departure. This obligation, known as withdrawal liability, recognizes the shared obligations of employers in maintaining an industry wide skilled labor pool in which employees may move among contributing employers dozens of times during their career. This system of shared risk has protected both the participants and the PBGC, as evidenced by the fact that it has had to intervene in fewer than 35 cases over the past 25 years. The reduced risk to the PBGC is also reflected in a much lower premium—$2.60 per participant per year, versus $19 per participant per year plus a variable premium for single-employer plans. The PBGC guarantees a much lower benefit for multi-employer plans—a maximum of $12,700 per year for a participant who retires at normal retirement age after 30 years of service (adjusted proportionally for greater or less service), compared with a maximum benefit under the single-employer guarantee of approximately $44,000 annually. As of the latest PBGC annual report, the multi-employer guaranty program showed a projected deficit of approximately 1 percent of that projected for the single-employer guaranty fund.

This system of pooled risk has been both one of the greatest strengths and major weaknesses of the multi-employer system. In the early 1980s, the presence, or even the threat of withdrawal liability produced a chilling effect on the growth of multi-employer plans that has persisted in several industries despite the fact that most have had no unfunded benefits for most of that time. On the other hand, for many, the threat of unfunded liabilities provided an incentive to plan fiduciaries to adopt and follow conservative funding and investment policies that, in combination with a robust economy, led the plans to become fully funded.

Nevertheless, rather than being able to build a buffer against future economic downturns, this success led plans to experience problems at the top of the funding spectrum. In the late 1980s and throughout the 1990s, plans began to hit the full funding limits of the tax code. Under these provisions, employers that contribute to plans in excess of these limits were precluded from receiving current deductions for their contributions to the plans. Compounding the situation, employers who continued to make their contributions also faced an excise tax for doing so, despite the fact that the collective bargaining agreements to which they were signatory obligated them to continue to make them. Although in rare instances the bargaining parties negotiated "contribution holidays," timing considerations and the fact that

in most cases the plan fiduciaries and bargaining parties were different people meant that plan trustees had no choice other than to increase plan costs by improving benefits to bring plan costs up to the level of plan income to protect the deductibility of employer contributions. Further, once adopted, many of the actions taken to improve the plan of benefits cannot be rescinded under the anti-cutback provisions of the law which have evolved since ERISA was first passed. It is estimated that over 75 percent of multi-employer defined benefit pension plans were forced to make these benefit improvements as a result of the maximum deductible limits. Overall, multi-employer plans were very well funded as the plans approached the end of the millennium, with the average funded position for all multi-employer plans at 97 percent (see The Segal Company Survey of the Funded Position of Multi-Employer Plans—2000).

In the 3 years that followed, however, these same plans suffered significant losses as the crisis of confidence over the accounting scandals and corporate excesses exemplified by Enron, Tyco, and WorldCom, sent the markets into a deep and prolonged contraction. For the first time since the ERISA funding rules were adopted in 1974; in fact, for the first time since before the beginning of World War II, the markets experienced 3 consecutive years of negative performance. Not only were plans unable to meet their long-term assumed rates of return on their investments, virtually all institutional investors saw the principal of their trusts decline. For many of these mature multi-employer plans that depend on investment income for as much as 80 percent of their total income, the loss of significant portions of the trust caused a rapid depletion of what for most had been significant credit balances in their funding standard accounts. Although the most recent report showing the funded position of multi-employer plans shows a significant decline from the 97 percent in 2000, the average funded position is still relatively healthy at 84 percent. Nevertheless, these investment losses have left a number of plans at all levels of funding facing credit balances approaching zero, meaning these plans face a funding deficiency in the near future (see The Segal Company Survey of the Funded Position of Multi-Employer Plans—2004). According to the most recent estimates, as many as 15 percent of all plans are projected to have a funding deficiency by the year 2008 and an additional 13 percent face the same fate by 2012 (assuming benefit levels and contribution rates remain unchanged).

The implications of a funding deficiency for contributing employers, the plans and their participants are potentially devastating. Once a plan's credit balance drops below zero, contributing employers are assessed by the plan trustees for additional contributions in an amount equal to their proportionate share of the amount necessary for the plan to meet its minimum funding requirements. This is above the amounts they have contributed pursuant to their collective bargaining agreements. In addition, they are required to pay an excise tax by the IRS equal to 5 percent of that assessment. In the event that all contributing employers fail to make up the shortfall in a timely fashion, the excise tax may be increased to 100 percent of the shortage.

For many of the contributing employers, especially those in industries (like, but not limited to, construction) which traditionally have small profit margins, they have bid their work throughout the year based on their fixed labor costs (including the negotiated pension contributions). For them, receiving an assessment for what could be multiples of the total contributed for the year, could be enough to drive them into bankruptcy. In this instance, the concept of pooled risk among contributing employers means that the shortage amounts as well as the excise taxes owed by the bankrupt employers would be redistributed among the remaining employers, invariably pulling some at the next tier into a similar fate. As more and more employers fail, those companies that are more financially secure begin to worry about being the "last man standing." The result is that they will also seek ways to abandon the plan before all of their assets are at risk. When all of the employers withdraw, the assets of the plan will be distributed in the form of benefit payments until the assets on hand are sufficiently depleted to qualify for assistance from the PBGC. At that point, participants' benefits will be reduced to the maximum guaranteed levels, as noted above, which are likely to represent only a fraction of the amount to which they would otherwise be entitled at normal retirement age.

A BALANCED, NEGOTIATED INDUSTRY-WIDE RESPONSE

Trustees of most plans faced with the prospects of an impending funding deficiency have already taken action to address the problem to the extent possible. For the most part, that has involved reducing future accrual rates or ancillary benefits that have not yet been accrued, as the current anti-cutback regulations prohibit reducing benefits that have already been accrued. In many cases, this has involved

substantial reductions (e.g. 40 percent by the Western Conference of Teamsters, 50 percent by the Sheet Metal Workers National Pension Plan and the Central States Teamsters Pension Plan, and 75 percent in the case of the Plumbers and Pipefitters National Pension Plan). But because the financial impact of adjusting only future benefits can be limited, these actions on their own may be insufficient to avoid a funding deficiency. Additionally, the modest recovery of the investment markets experienced in 2004 is only marginally helpful. For example, a $1 billion fund in 2000 that suffered a 20 percent decline in assets through 2003 would have to realize an annualized rate of return of 15 percent every year for the remainder of the decade to get to the financial position by 2010 it would have had it achieved a steady rate of 7.5 percent for the full 10 year period. Other relief, including funding amortization extensions under IRC section 412(e) or the use of the Shortfall Funding Method, have been effectively precluded as options by the IRS. Consequently, the only alternative available requires a legislative solution.

Following the failed attempt at relief in the Pension Funding Equity Act of 2004, various groups began to evaluate alternatives that might help plans get by avoidable situations, while attempting to help plans that were placed at risk by unavoidable external forces. The objective was to find ways to provide additional tools to the plan fiduciaries and bargaining parties for plans that face imminent funding deficiencies to bring liabilities and resources into balance. From April 2004 through early May 2005 a broad cross section of groups, including those that were on different sides in the earlier debate, entered into extensive negotiations to develop a set of specifications for reform that the full group could agree on. The specifications for reform that resulted from those negotiations reflect a carefully conceived compromise between employer and labor groups, undoubtedly quite different from what either group would have designed independently, but reflective of a desire by all parties to preserve the plans and the maximum benefits payable to plan participants today and in the future. That initial group was expanded through meetings with numerous employer and labor groups and the result was the current coalition proposal, a copy of which is included as an addendum to this testimony. A summary of that proposal is as follows:

SUMMARY OF COALITION PROPOSAL

The proposed specifications for multi-employer reform is comprised of three major components and supplemented with several clarifying and remedial changes intended to make the system work more effectively for plans, their participants and sponsors.

The first component is applicable to all plans and has two major provisions geared to strengthening funding requirements for plan amendments that increase or decrease plan costs (specifically unfunded actuarial accrued liabilities) related to past service and to shorten the amortization of costs for improvements that are to be paid out over a shorter period to the payment period.

The other major provision would allow plans to build a "cushion" against future contractions in the plan's funded position by increasing the maximum deductible limit to 140 percent of the current limits and would repeal the combined limit on deductions for multi-employer defined benefit and defined contribution plans.

The second component applies to plans that have potential funding problems, defined in the coalition proposal as being plans that have a funded ratio of less than 80 percent using the market value of assets compared to the actuarial value of its actuarial accrued liability. Such plans would be required to develop and adopt a "benefit security plan" that would improve the plan's funded status. Plans in this category would not be able to adopt amendments to improve benefits unless the additional contributions related to such amendment more than offset the additional costs to the plan. Amendments that violate that restriction would be void, the participants would be notified and the benefit increase would be cancelled.

To provide additional tools to plans to avoid funding problems, plans would have "fast track" access to 5 year amortization extensions and the Shortfall Funding Method if certain criteria were met. IRS authorization could be withheld only in certain circumstances and applications would need to be acted upon within 90 days or the approval would be automatic. Additional restrictions that currently apply to plans with amortization extensions would also apply.

The third and most critical component involves plans that have severe funding problems or will be unable to pay promised benefits in the near future. The clear intent of this provision is to prevent a funding deficiency that could trigger a downward spiral of the plan and its contributing employers and a reduction in the ultimate benefit payable to the PBGC guarantee levels. This is accomplished by provid-

ing the bargaining parties with additional tools beyond those currently available to bring the plan's liabilities and resources back into balance.

The proposal modifies the current reorganization rules to provide a meaningful option to plan sponsors, much like a Chapter 11 bankruptcy reorganization. ERISA currently has reorganization rules governing plans that are nearing insolvency, but those rules were adopted at a time when the major concern was a plan's ability to meet its payment obligations to current pensioners. Today, even those plans with the most severe funding problems have sufficient assets to meet their obligations to current pensioners. The coalition proposal suggests several new triggers to reorganization that reflect the problems of mature plans, recognizing that funding ratios below 65 percent, a plan's short term solvency and a plan's demographic characteristics (i.e. the relationship between the present value of benefits earned by inactive vested and retired participants to that of currently active participants) can play an important role in a plan's ability to meet its obligations to all participants, current and future.

Once a plan is in reorganization, notice would be given to all stakeholders and the Government Agencies with jurisdiction over the plans that the plan is in reorganization and describing the possible consequences. Once in reorganization, plans would be prohibited from paying out full or partial lump sums, social security level income options for people not already in pay status, or other 417(e) benefits (except for the $5,000 small annuity cash outs). Within 30 days, contributing employers would be required to begin paying a surcharge of 5 percent above their negotiated contribution rates. If the bargaining agreement covering such contributions expires more than 1 year from the date of reorganization, the surcharge would increase to 10 percent above the negotiated rate and remain there until next round of bargaining. Once in reorganization, the normal funding standard account continues to run, but no excise taxes or supplemental contributions will be imposed if the plan encounters a funding deficiency.

Not later than 75 days before the end of the 1 year of reorganization, the plan fiduciaries must develop a rehabilitation plan to take the plan out of reorganization within 10 years. The plan would set forth the combination of contribution increases, expense reductions (including possible mergers), benefit reductions and funding relief measures (including amortization extensions) that would need to be adopted by the plan or bargaining parties to achieve that objective. Annual updates to the plan of rehabilitation would need to be adopted and reported to the affected stakeholders. Although the proposal anticipates the loosening of the current anti-cutback rules with respect to ancillary benefits (such as subsidized early retirement benefits, subsidized joint and survivor benefits, and disability benefits not yet in pay status), a participant's core retirement benefit at normal retirement age would not be reduced. Additionally, with one minor exception which follows current law regarding benefit increases in effect less than 60 months, no benefit for pensioners already in pay status would be affected. Finally benefit accruals for active employees could not be reduced below a specified "floor" as a means of ensuring that the active employees whose contributions support all plan funding, remain committed to the plan.

The proposal anticipates that these ancillary benefits become available as part of a menu of benefits that can be modified to protect plans from collapsing under the weight of previously adopted plan improvements that are no longer sustainable, but that cannot be modified under the current anti-cutback restrictions. Without such relief participants would receive lower overall benefits on plan termination and the plan would be eliminated for future generations of workers. Within 75 days of the end of the first year a plan is in reorganization, the plan trustees must provide the bargaining parties with a schedule of benefit modifications and other measures required to bring the plan out of reorganization under the current contribution structure (excluding applicable surcharges). If benefit reductions alone are insufficient to bring the plan out of reorganization, the trustees shall include the amount of contribution increases necessary to bring the plan out of reorganization (notwithstanding the floor on benefit accruals noted above). The trustees shall also provide any other reasonable schedule requested by the bargaining parties they deem appropriate.

The bargaining parties will then negotiate over the appropriate combination from among the options provided by the trustees. Under this proposal, benefits for inactive vested participants are subject to reduction to harmonize the impact on future benefits for this group as well as for active participants.

The proposal includes suggestions for: bringing the current rules on insolvency in line with the proposed reorganization rules; strengthening withdrawal liability provisions; and providing construction industry funds with additional flexibility currently available to other industries to encourage additional employer participation. It also addresses recent court rulings, with one amendment that allows trustees to

adjust the rules under which retirees can return to work and still receive their pension benefits and another that permits plans to rescind gratuitous benefit improvements for current retirees adopted after the date they retired and stopped generating employer contributions.

CONCLUSION

For more than half a century, multi-employer plans have provided benefits for tens of millions of employees who, using standard corporate rules of eligibility and vesting, would never have become eligible. They offer full portability as workers move from one employer to another in a system that should be held out as a model for all defined benefit plans. More importantly, the system of collective bargaining and the checks and balances offered by joint employer—employee management has enabled the private sector to take care of its own without the need for Government support.

Yet the current funding rules, previously untested under the unprecedented unfavorable investment climate experienced in recent years, have the potential not only to undermine the retirement income security of millions of current and future workers and their dependents, but to force large numbers of small businesses out of business and eliminating participants' jobs.

The United States Senate and House of Representatives have been presented with an ideal opportunity to enact meaningful reform supported by both the employer and employee community who have coalesced behind a responsible proposal that will enhance plan funding and provide safeguards to plans, participants, sponsoring employers and the PBGC, without adding to the already burgeoning debt. Although the proposal includes certain provisions that are distasteful to both parties, it is a compromise product of careful negotiations by employers and the employees' legally recognized representatives. The alternative is not the continuation of the status quo, but a much worse fate that includes: the loss not only of accrued ancillary benefits, but a substantial portion of a participant's normal retirement benefit as plans are assumed by the PBGC; the demise of potentially large numbers of small businesses and the loss, not only of pension benefits, but the jobs from which such benefits stem; and an increase in taxpayer exposure at the PBGC, an agency that is already overburdened.

We urge the committee to wholeheartedly support this proposal and look forward to working with you to see it enacted into law.

In closing, I would like to thank you for taking the time to engage in this important discussion and for the opportunity to be with you here today.

Senator DEWINE. Mr. Noddle?

Mr. NODDLE. Chairman DeWine, Senator Mikulski, thank you for allowing me to testify. As you put it, I am Chairman of the Board, President and Chief Executive Officer of SUPERVALU. I am also Chairman of the Board of the Food Marketing Institute, which represents 26,000 retail food stores, and I am also a Board member of the IGA Independent Grocers Alliance.

SUPERVALU is a Minnesota based Fortune 100 company with 58,000 employees in 41 States. As you pointed out, we are the largest publicly held food wholesaler and the seventh largest food company in the United States. SUPERVALU participates in 17 defined benefit multi-employer plans, providing retirement benefits to approximately 22,000 of our SUPERVALU employees.

Overall, supermarkets employ 3.5 million Americans. About 1.33 million of these are covered by collective bargaining agreements. While the industry provides a variety of single-employer and multi-employer retirement plans, most of the union workforce participates in multi-employer pension plans. In total, multi-employer pension plans cover about 9.7 million people. They are governed by ERISA like their single-employer plan counterparts. Unlike single-employer plans, however, multi-employer plans are also governed by the Multi-Employer Pension Plan Amendment Act of 1980 and the Taft-Hartley Act, which requires plans' boards of trustees to have equal representation by both union and management.

Multi-employer plans are funded by employer contributions and governed by joint boards of trustees. They are not union plans. Two of the biggest differences between single-employer and multi-employer plans are the funding mechanisms that are used and the manner in which benefit levels are established. In a single-employer plan, companies generally establish a benefit level first with the contribution level increasing or decreasing each year. Multi-employer plans generally work in the opposite manner. Contributions are almost always established first through the collective bargaining process. Then benefit levels are set by a plan's joint board of trustees.

Given this background, I ask you to support FMI's pension reform proposals. We believe they provide a reasonable framework for multi-employer plans to work through the problems now facing all pension plans. We are not asking for a Government bailout. Rather, we ask you to help us establish a framework to solve our own pension problems without putting financial pressure on the PBGC.

First, we seek greater transparency of information from multi-employer plans. Employers have great difficulty in obtaining current financial information unless they serve on the board of trustees. We believe plans should be required to provide the most current financial information upon request to both contributing employers and plan participants. Without current financial information, companies cannot engage in collective bargaining in an informed manner and work with the plan trustees to address any underfunding problems.

In the case of SUPERVALU, as I mentioned, we have 17 plans, but we only have trustees on 7 of those so the transparency issue is quite vital to us on the balance of those plans.

Second, we ask Congress to adopt mechanisms to allow boards of trustees to better manage their funding. Our proposals dovetail well with the coalition proposal that includes a stoplight system of identification for plan funding. Green Zone plans are more than 80 percent funded, Yellow Zone plans are 65 to 80 percent, and Red Zone plans are less than 65 percent. The FMI proposal focuses on Yellow Zone plans providing a more specific mechanism to address funding concerns. Allow me to applaud the coalition efforts of employees and labor to tackle these very important issues in hopes of a meaningful reform.

Our proposal creates an early warning system that requires plan actuaries and boards of trustees to look at both the plan's current funding level and 7 years into the future. As a result, future funding problems are recognized early when there is time to correct them before the plan reaches a crisis stage. When a plan falls within the Yellow Zone the trustees must prepare a funding improvement plan using quantifiable benchmarks to improve the plan's funding. The trustees must also adopt a schedule of solutions to allow employers and unions engaged in collective bargaining to agree to contribution levels that are appropriate for the benefits provided by the plan.

We believe this mechanism addresses the unique nature of multi-employer plans where collective bargaining agreements fix contribution rates for several years into the future.

Again, Chairman DeWine, Senator Mikulski, I thank you for the opportunity to testify on this topic, and I will be glad later to answer questions.

[The prepared statement of Mr. Noddle follows:]

PREPARED STATEMENT OF JEFFREY NODDLE

Chairman DeWine, Senator Mikulski and members of the committee, good morning. My name is Jeff Noddle and I am the chairman of the board, president and chief executive officer for SUPERVALU INC. I am currently chairman of the board for the Food Marketing Institute (FMI), as well as a board member for the Independent Grocers Alliance, Inc. (IGA) and chairman of its governance committee, as well as other corporate, civic and industry organizations. In addition, I serve on the board of the Food Industry Center at the University of Minnesota and the Academy of Food Marketing at Saint Joseph's University, Pennsylvania.

I want to thank you for the opportunity to testify on behalf of the 26,000 retail food stores represented by FMI regarding legislation to achieve comprehensive pension reform and retirement security. We would like to share our concerns about the future of multi-employer plans and some suggestions we have for better management of these plans.

Before I proceed, I would like to take a moment to tell you about my company. SUPERVALU INC., is a Fortune 100 company, based in Minneapolis, MN. We are the largest publicly held food wholesaler in the United States and this country's 7th largest grocery retailer. SUPERVALU manages a well-rounded portfolio of national and regional grocery retail banners that we constantly refine to address dynamic customer preferences and trends in the market. Since 1870, the enduring mission of our 58,000 employees is to serve our customers better than anyone else could serve them.

Each week, SUPERVALU serves over 10 million customers in its more than 1,500 corporately owned stores in 41 States. Our corporate retail stores include Cub Foods in Minnesota, Wisconsin and Illinois, Bigg's in Ohio, Shopper's Food Warehouse in Virginia and Maryland, Shop-N-Save in Missouri, Illinois and Pennsylvania, and Save-A-Lot throughout the country. We operate 41 distribution centers, which supply more than 3,200 independent stores, in addition to our corporate banners.

SUPERVALU participates in 17 defined benefit multi-employer plans, providing retirement benefits to approximately 22,000 SUPERVALU employees throughout the United States.

Industry-wide, supermarkets employ approximately 3.5 million Americans, providing employees with good wages and excellent benefits, so employment in the industry is a proven path to success for the American worker. The industry provides a variety of retirement plans among the wide range of benefits it provides. Supermarkets offer benefits to associates and management alike through almost every conceivable type of pension plan, including defined benefit, defined contribution—profit sharing and 401(k), hybrid, cash balance and employee stock ownership plans. The industry's defined benefit pension plans include both single-employer plans (those sponsored by an individual company and common in the steel, automotive and airline industries) and multi-employer plans, in which many companies join together to fund and operate the plans (common in the grocery and construction industries).

Multi-employer plans are governed, in part, by ERISA, like their single-employer plan counterparts. Unlike single-employer plans, however, multi-employer plans are also governed by the Taft-Hartley Act, which mandates that their Boards of Trustees have equal representation by Union and Management Trustees. They are also governed by the Multi-Employer Pension Plan Amendments Act of 1980, which amended ERISA and provided special rules for multi-employer pension plans.

Approximately 1.33 million people in the supermarket workforce are covered by collective bargaining agreements (labor contracts). Unionized associates who work in the stores are primarily represented by the United Food & Commercial Workers Union. Warehouse workers and drivers are generally represented by the International Brotherhood of Teamsters. Most of these employees are participants in multi-employer pension plans.

Multi-employer pension plans are an important part of the Nation's private sector retirement system, providing pension benefits for approximately 9.7 million workers and retirees in the United States. As I mentioned earlier, in 1980, Congress recognized some of the funding and operational differences between single-employer pension plans and multi-employer pension plans. As a result, Congress amended ERISA and established separate and distinct rules for multi-employer plans under the

Multi-Employer Pension Plan Amendments Act of 1980. Multi-employer plans provide retirement coverage for unionized employees of multiple employers within an industry or trade. The multi-employer plans are NOT union plans.

Two of the biggest differences between single-employer pension plans and multi-employer plans are the funding mechanism used and the manner in which benefit levels are established. In a single-employer plan, companies generally establish a benefit level first, with the contribution level increasing or decreasing each year depending upon changes in a plan's demographics as well as investment gains or losses during each plan year. Conversely, contributions to multi-employer plans are almost universally set at fixed rates established through collective bargaining by contributing employers and Unions representing the companies' employees. Benefit levels are then set by a plan's Board of Trustees, which, as I stated earlier, must consist of an equal number of representatives of Employers and Unions.

This funding mechanism and the tax laws existing under ERISA in the late 1990s contributed to some of the funding problems multi-employer plans currently encounter. In the late 1990s, these plans' investment gains caused many plans to become overfunded to the point at which contributing companies' contributions (which were fixed by collective bargaining agreements) would not be treated as deductible contributions under the Internal Revenue Code if benefits were not increased (known as the full funding limit). A host of multi-employer plans attempted to reward long-term participants by increasing benefit levels retroactively under the theory that the long-term participants should be rewarded for the prior contributions made on their behalf and the resulting investment gains from those contributions. When the stock markets suffered huge losses from 2000–2002, these plans were unable to decrease the benefits granted for past service due to restrictions under ERISA. Even plans that did not increase benefits for past service suffered greatly from the 2000–2002 bear market.

Another difference between single-employer plans and multi-employer plans is the amount of control any one employer has over the operation of a multi-employer plan. As I stated earlier, the Board of Trustees of multi-employer plans are required by law to be managed by Boards of Trustees equally represented by Unions and Employers. Most Boards of Trustees consist of 3–4 Union representatives and 3–4 Employer representatives. Unless a company employs a large percentage of the plan's participants, it generally does not have a representative on the Board of Trustees. Furthermore, in many cases, employers do not even have the ability to vote on who represents them on the Board of Trustees. As a result, many employers who bargain in good faith with Unions to contribute to these plans and make contributions in good faith to these plans have no say in the operation of the plans and, in fact, receive little or no information concerning the plans' operations or funding levels.

Chain supermarket companies generally participate in several local, regional or national plans, depending on the company's size and area of operation. Some companies participate in as many as 50 multi-employer pension plans. So, it is common for even large employers to contribute to many multi-employer plans on which they do not have a Trustee seat. For example, while SUPERVALU contributes to 17 multi-employer pension plans, we have a Trustee seat on only 7 of these plans.

A third difference between single-employer plans and multi-employer plans is in the amount of Government intervention with plans supported by companies that go bankrupt. In the single-employer plan arena, pension plans of bankrupt companies generally are taken over by the Pension Benefit Guarantee Corporation, which guarantees a reduced benefit to plan participants and is financially responsible to pay this benefit. This results in a financial burden on the PBGC. Conversely, when a contributing employer to a multi-employer plan goes bankrupt, the plan absorbs the loss, the company's employees continue to receive unreduced pension benefits, and the remaining contributing employers are required to bear the burden of paying these pension benefits. In fact, even when a multi-employer plan has a withdrawal liability claim against the bankrupt employer it rarely, if ever, collects the full amount of the claim because withdrawal liability claims are treated as general unsecured claims under the current bankruptcy laws. The Pension Benefit Guarantee Corporation is rarely called upon to assist multi-employer plans due to these rules. Even if the PBGC is needed to assist a multi-employer plan that, as a whole, becomes insolvent, the PBGC assistance is only in the form of a loan and solvent contributing employers are called upon to increase contributions to the plan, over and above any amounts they agreed to contribute through collective bargaining.

As an example, a food industry company, Fleming Companies, filed for bankruptcy in 2003. Fleming had a single-employer pension plan that was taken over by the PBGC, which is required to shoulder the financial burden of paying benefits to the plan's participants. As part of the law under which the PBGC operates, plan participants and retirees may have their retirement benefits reduced. Fleming Com-

panies also contributed to several multi-employer pension plans on behalf of its unionized employees. The PBGC did not step in to provide financial assistance for these multi-employer plans and unionized employees did not have their retirement benefits reduced. Rather, other employers contributing to the multi-employer plans are required by law to absorb any funding deficiency. In the case of Fleming, we estimate this amounts to over $100 million dollars spread throughout several multi-employer plans. Finally, even though these multi-employer plans were able to file claims for withdrawal liability with the bankruptcy court, we understand the plans received only 5–10 cents on the dollar for their claims because, under bankruptcy law, the plans are unsecured creditors.

Given this background, I am here today to ask you to support the supermarket and food distribution industry's proposals to modify the laws governing multi-employer pension plans. We believe these proposals will provide a reasonable and rational framework for multi-employer pension plans to work through the problems now facing all pension plans (both single-employer and multi-employer). We are not asking for a Government bail out; rather, we are asking you to help us establish a framework that will allow us to solve our own pension problems without monetary intervention by the Government and without putting financial pressures on the Pension Benefit Guarantee Corporation. We believe that, if Congress acts now, multi-employer plans can solve their own problems so they do not become a burden on the Federal Government.

Our proposed reform focuses on two areas. First, we seek greater transparency of information from multi-employer plans. Second, we ask Congress to adopt mechanisms to allow Boards of Trustees to manage their own funding situations in a better manner.

As for transparency, the supermarket and food distribution industry is very concerned about the lack of transparency in multi-employer plans. Some of these plans are seriously underfunded, but employers have had considerable difficulty in obtaining current financial information about the funding deficiency. We believe there should be rules requiring these plans to provide the most current financial information, upon request, to both contributing employers and plan participants. In a single-employer plan, the employer has direct and continual involvement in the financial management of their pension plan; there is no such direct involvement by employers in multi-employer plans. Without this current information, it is difficult to engage in collective bargaining in an informed manner and to work with the plan trustees to address the underfunding problem.

Our industry's second area of proposed reform attempts to provide a mechanism for underfunded plans to work through their funding issues. It is a proposal that would dovetail well with a proposal put forth by the trucking industry. Earlier this year a group within the trucking industry, including, United Parcel Service, YellowRoadway, the Motor Freight Carriers Association, the International Brotherhood of Teamsters, the National Coordinating Committee on Multi-Employer Plans (NCCMP) and Central States Teamsters Pension Plan, came together and negotiated a proposal to address funding reforms. Their proposal focused on plans with funding levels below 65 percent. It also included a proposal for plans that are between 65 percent and 80 percent funded. At the same time, FMI and members of its Pension Task Force were independently developing long-term pension reform proposals. Earlier this year, FMI met with the trucking industry to discuss our respective visions of multi-employer pension plan reform.

FMI applauds the trucking industry's efforts. Due to philosophical differences, we came out of our discussions with different, but complimentary policy proposals. The trucking industry proposal includes a stop-light system of identification for multi-employer pension plan finding, which includes Green Zone plans (above 80 percent funded), Yellow Zone plans (65 percent–80 percent funded), and Red Zone plans (less than 65 percent funded).

FMI's Task Force focused on the Yellow Zone plans, providing what we believe is a more specific mechanism to allow Yellow Zone plans to address their funding concerns. As a result, the FMI member companies drafted ideas for benchmarks, transparency, and funding reform that we believe will wrap around the trucking industry's proposals and provide comprehensive funding reform that will serve all multi-employer plans well into the future.

The FMI Task Force formulated its proposals in meetings with top actuaries and pension attorneys, where it became evident that the requirements of today's laws encourage plans to take a short-term, "snapshot" approach to determine their benefit formulas and funding requirements at the expense of sound long-term funding projections. The FMI Yellow Zone proposal attempts to create a mechanism whereby multi-employer plan actuaries are required to look at both the plan's current funding level and far ahead into the future (7 years) to make sure the plan will remain

at an appropriate funding level. As a result, potential future funding problems are recognized early, when there is time to correct them in a reasonable and timely manner. This time is needed to allow the Boards of Trustees to act to adopt objective measures to improve a Yellow Zone plan and prevent it from becoming a Red Zone plan.

Once a Yellow Zone plan is identified as such, the plan's Board of Trustees will be required to prepare a Funding Improvement Plan that will improve the plan's funding ratio (within specified guidelines) and will postpone any deficiency in the plan's funding standard account. The trustees will also be required to adopt a schedule of solutions that will allow employers and unions engaged in collective bargaining in the future to agree to contribution levels that are appropriate for the benefits provided by the plan. The schedule of solutions in the FMI Yellow Zone proposal ranges from employer contribution increases to reductions in future employee benefit accruals, or a combination of both.

We believe that creating this mechanism will accurately address the unique nature of multi-employer plans, in which collective bargaining agreements fix contribution rates for several years into the future and where, under ERISA, trustees are prohibited from retroactively reducing the benefit levels for plan participants. As a result, all parties (contributing employers, unions, and trustees) will have the ability to act responsibly on behalf of employees by providing an accurate measure of expected liabilities over a longer time-frame and by providing a schedule of solutions to correct any funding problems on the horizon before they reach a crisis stage. We believe the FMI Yellow Zone proposal provides these solutions in a manner that will also maintain the collective bargaining rights of all the parties.

While many of the multi-employer plans in our industry are well funded, the funding standard account in some of these plans could reach a crisis state in 4 to 6 years if some of the laws governing these plans are not changed. Even plans that are currently 100 percent funded could have a significant deficiency in their standard funding account in future years. Therefore, we urge Congress to act now so defined benefit multi-employer pension plans can remain an important part of the Nation's retirement system well into the future.

In summary, we in the retail food industry are very concerned about the Nation's pension funding and retirement funding problems. Those of us who contribute to and participate in multi-employer pension plans are asking Congress to recognize the ways in which these plans differ from single-employer pension plans and to enact amendments to existing laws that will establish mechanisms to help us correct our problems ourselves. Multi-employer pension plans have not, in the past, been a burden to the Federal Government or the PBGC, and we are not now asking for any financial assistance from the Government. Rather, we ask for your help now, so we can continue to provide great retirement benefits for our millions of employees and retirees well into the future without ever becoming a burden on the Federal Government.

Again, Chairman DeWine, Senator Mikulski and members of this committee, I thank you for the opportunity to testify on this important topic. I am glad to answer any of your questions.

(Food Marketing Institute (FMI) conducts programs in research, education, industry relations and public affairs on behalf of its 1,500 member companies—food retailers and wholesalers—in the United States and around the world. FMI's U.S. members operate approximately 26,000 retail food stores with a combined annual sales volume of $340 billion—three-quarters of all food retail store sales in the United States. FMI's retail membership is composed of large multi-store chains, regional firms and independent supermarkets. Its international membership includes 200 companies from 50 countries).

Senator DEWINE. Mr. Ward?

Mr. WARD. Chairman DeWine, Senator Mikulski, thank you for having me. My name is John Ward, and I am the President of Standard Forwarding Company, a small, family owned union trucking company located in East Moline, IL. I appear before you today both on behalf of my company and the members of the Multi-Employer Alliance.

Our alliance was formed in 2004 to represent the interests of smaller, family owned businesses. All our members participate in the Teamsters Central States Plan, which is now severely underfunded by 11 to 15 billion and incurred a funding deficiency last year.

Significant underfunding of these plans will result in deficiency penalties being imposed upon us, imperiling our businesses and our employees.

Despite never missing a pension contribution, and despite having no say in who or how the plans are run, our share of the plans unfunded liability now significantly exceeds the net worth of our small businesses.

Standard Forwarding is typical of the firms that make up the alliance. Our company was founded in 1934 and provides transportation services to Midwestern firms. We employ 440 people and generate in excess of 50 million in annual revenue. Standard Forwarding has been a union firm for the majority of our 71 years. We believe that our Teamster employees are among the best in the industry. As demand for our services has grown, we have expanded our workforce with union employees.

Unfortunately, every additional employee that I hire increases our portion of the unfunded pension liability. In 2001 our company employed 211 Teamsters and had a withdrawal liability of $3.2 million. Three years later we employed 290 Teamsters and had a withdrawal liability of $20 million. The liability exceeded our net worth by $16 million, and mind you, this is a successful, profitable company.

Ironically, the Multi-Employer Act of 1980 severely penalizes companies like ours for growing union jobs. The alliance recommends various reforms to current law that are urgently needed to protect the benefits of workers and save our companies. The most pressing need is to repeal current law that imposes excise taxes and additional contributions on employers when a plan reaches funding deficiency. These potential costs are beyond our ability to pay. We support much of the funding deficiency reforms in the UPS Teamsters legislative proposal.

However, it is vital that we secure additional safeguards to prevent the plans from imposing unlimited additional contributions which could bankrupt our companies. Congress should resist proposals to impose withdrawal liability on a company that uses independent contractors or driver leasing companies. Controlled group rules should be limited so that withdrawal liability is confined to the contributing employer or when entities are solely created to avoid liability.

We support establishing objective funding standards that would prohibit benefit increases when there is insufficient income and assets to fund them. Congress should also permit funding of plans up to 140 percent without penalty. More timely and accurate disclosure of financial information by the plans is obviously necessary.

Last, we urge Congress to restore the provisions of ERISA that existed prior to the passing of MEPA in 1980. At that time a company's portion of the unfunded liability was limited to 30 percent of its net worth. It is patently unfair and contrary to the principles of the American dream that any employer should lose all of the equity built up over generations. There has been a steady decline in the number of multi-employer plans, from 2,200 in 1980 to 1,700 in 2003. It is no coincidence that this decline occurred with the passing of MEPA.

In 1982, George Lehr, the Executive Director of the Central States pension plan, said, and I quote, "In the long run, employer liability is the single most damaging thing pension funds will be facing. In theory, it's a wonderful law; in practice, it doesn't work." History has proven Mr. Lehr right.

Congress must create an environment that encourages existing and new employers to participate in these plans. Current law has created an iron curtain that simply drives employers away. Our suggested reforms provide balance to the UPS Teamsters proposal. They would protect workers' benefits and the vitality of the small companies that employ them.

Thank you very much for the opportunity to appear, and I would be happy to answer any questions.

Senator DEWINE. Good.

[The prepared statement of Mr. Ward follows:]

PREPARED STATEMENT OF JOHN WARD

EXECUTIVE SUMMARY

Chairman DeWine, Senator Mikulski and members of the subcommittee, I thank you for the opportunity to testify on multi-employer pension plans. My name is John Ward and I am the President of Standard Forwarding Company which is a small, family owned union trucking company located in East Moline, Illinois. I appear before this subcommittee both on behalf of my company and the other trucking company members of the Multi-Employer Pension Plan Alliance (MEPA Alliance).

The MEPA Alliance was formed last year in response to the financial crisis that arose in the Central States pension plan to which we all are long time contributing employers. It is an understatement to say we were shocked to learn that this plan had become so severely underfunded that it reached a deficiency in 2004 that would trigger Federal excise tax penalties and additional contributions that our companies could not afford to pay.

Unless significant reform is enacted multi-employer plans will ultimately lose the fight. Rather than creating an environment that encourages employers to grow their businesses and participate in these plans, the law has created a death spiral with traps and penalties that will forever drive current and prospective employers away. In fact, in a March 5, 1982 Wall Street Journal article, George Lehr, the Executive Director of the Central States pension plan said in a reference to withdrawal liability: "In theory, it's a wonderful law; in practice, it doesn't work. In the long run, employer liability is the single most damaging thing pension funds will be facing."

[Exhibit 1—See Editors note after the conclusion of this statement.]

The smaller businesses that have participated in the Central States pension plan were kept in the dark about its financial deterioration; neither the plan administrator nor the trustees informed us of the dire financial condition until they needed our assistance in seeking legislation that would allow them to postpone this deficiency. At that time, we realized that we needed to seek our own representation and make our case for meaningful reform of these plans and the governing law.

The alternative of doing nothing places in jeopardy the future of smaller, family owned companies, such as Standard Forwarding, that have been built up and have operated over several generations. Substantive legislative reform of multi-employer pension laws is the single most important legislative issue now confronting the unionized trucking industry.

Unless Congress addresses this year the chronic and now dire underfunding in many of the Teamster multi-employer plans, many smaller union firms will be forced into bankruptcy. We face a classic case of double jeopardy. We cannot afford current law on funding deficiency that mandates additional contributions and excise tax penalties. We also cannot afford the portion of the UPS/Teamsters reform proposal which permits the Funds to establish unlimited levels of pension contributions and then expel companies for not paying. If we are expelled from the Central States pension plan, our companies will be forced to pay a withdrawal liability that has grown so large that it now substantially exceeds the net worth of our companies. Obviously, this means immediate bankruptcy.

We desperately need the assistance of Congress and we need it soon. We appreciate that Congress is willing to address not only reforms to the single-employer de-

fined benefit system, but also to the multi-employer pension plan system. Both are at risk today.

The MEPA Alliance members recommend that this subcommittee focus on the following critical areas:

• Repeal of the current tax law that imposes punitive excise taxes and additional contributions on employers in severely underfunded plans. We generally support some aspects of the reform proposals developed by other groups, but with a safeguard so that plans may not expel smaller employers and impose withdrawal liability if they cannot bear the cost of the plan-imposed additional pension contributions. Plan-imposed contributions should be capped at 15 percent above the employer's contributions under its prior collective bargaining agreement.

• Ideally, the withdrawal liability rules should be repealed, rather than tightened. Short of this, we support reenactment of the law prior to the Multi-Employer Pension Plan Amendments Act of 1980 (MPPAA) that properly and fairly held that no more than 30 percent of any employer's net worth can be taken when it withdraws from an underfunded plan. It is patently unfair that a family owned company can be stripped of all of the assets it has built up over generations notwithstanding that the company has made all its required pension contributions.

• Refrain from making the withdrawal liability rules even more onerous as UPS/Teamsters have proposed. That proposal would impose withdrawal liability when a company uses independent contractors or third party driver leasing companies to meet customer needs. The trucking industry rule should not be repealed and the current rule that reduces liability for a company in liquidation should be maintained. As will be discussed, the withdrawal liability rules established in 1980 have discouraged new employers from entering these plans and have sealed the fate of these plans by causing a declining participation base.

• Limit the controlled group rules so that withdrawal liability is confined to the contributing employer and any related, fractionalized entities that were separated out from the contributing employer to avoid withdrawal liability. We also support repealing the "pay now and dispute later" provisions of MPPAA.

• Establish objective funding standards for all plans that would prohibit benefit increases when there is insufficient income and assets to fund those benefit promises. Benefit increases should not be allowed in plans that have a funding ratio below 90 percent. As early as 1996, the Multi-Employer Plan Solvency Coalition reported that trustees of the Central States plan had imprudently increased benefits beyond the means to pay for them and that it would exacerbate the underfunding crisis. Benefit promises should be made only when they can be paid. Similarly, the Alliance believes that Congress should move to eliminate or substantially increase any high end caps on funding of the plans and permit funding up to 140 percent of full funding without penalty.

• Require timely and accurate disclosure of the key financial information by the plans to all participating employers, their employees and the PBGC. There needs to be sunshine in the dark rooms of these plans that have withheld information from contributing employers and plan participants in the past. Too much is at stake to tolerate the nondisclosure of this financial and actuarial data to all but the union and the employer companies that have trustees on these plans.

• Create an objective Congressional Commission to study and make recommendations on how to fairly apportion and pay for the huge underfunding that has arisen in these plans, and in particular the benefits being paid to retirees that no longer have an employer contributing to these plans. The Central States plan currently pays approximately $1 billion annually to 100,000 retirees that lack a contributing employer. Those benefits consume nearly 100 percent of the annual contributions received by the plan from all the remaining employers. Contributing employers can no longer shoulder this entire burden which is mounting each year.

The Alliance members are committed to achieving these legislative reforms for multi-employer plans to promote plan solvency, preserve pension benefits and save our smaller companies through a fair realignment of pension responsibilities and liabilities.

THE PLIGHT OF SMALLER BUSINESSES LIKE STANDARD FORWARDING

Standard Forwarding is typical of the transportation firms that make up the Alliance members. Our company, based in East Moline, Illinois, was founded in 1934 and provides transportation services to companies over the five State area of Iowa, Illinois, Indiana, Minnesota and Wisconsin. Our dedicated employees deliver a high quality of service that has been a factor in the success of our customers which in turn has driven our expansion. We now employ 440 employees, generate over $50

million in revenue annually, operate 250 tractors and 700 trailers, and use the latest information technology found in the trucking industry.

Standard Forwarding has been a union-represented trucking company for the majority of our 71 years in business. We believe our Teamster employees are among the best trucking employees in the industry. As demand for our services has grown, Standard Forwarding, unlike many contributing employers to the Central States pension plan, has expanded our union workforce. Unfortunately, every additional union employee I hire only increases our portion of the unfunded pension liability in this plan. This liability has increased at a cruel pace that exceeds any profitability or equity growth that our company could ever hope to generate. Consider that in 2001, Standard Forwarding employed 211 union employees and had a withdrawal liability of $3.2 million. This was $2 million more than our corporate equity. A mere 3 years later, in 2004, we had increased our union employees to 292 and our withdrawal liability had mushroomed to $20 million, which exceeded our equity by $16 million!

As hard as it may be to believe, the Federal pension law created by the Multi-Employer Pension Plan Amendment Act of 1980 severely penalizes our company, and other companies like it, for growing union jobs.

In fact, that law has also made it impossible to sell our company. No prudent investor is willing to inherit the mounting liabilities that come with acquiring a unionized firm that participates in an underfunded plan, such as the Central States plan.

Contrary to the principles of the American dream, growing our company significantly increases our liability and wipes out any stake that we may have built up in our businesses. Sadly, MPPAA even precludes us from applying our expertise to other business ventures. Under the so-called controlled group regulations, the assets of an affiliated company are also at risk to pay for withdrawal liability if the owners have controlling interest in both Standard Forwarding and the affiliated company.

Many of you on this subcommittee may be or once may have been owners of small businesses or worked in a family owned business. Consider for a moment what you would do if your family business were faced with a decision to participate in a multi-employer pension plan like Central States? Would you do it knowing that one day you could wake up and your family's life work was wiped out because of it? That is the stark reality I face with Standard Forwarding. It is a nightmare that I share with all the Alliance members. Only Congress has the ability to rectify the problem.

Smaller businesses lack both the capital and diversification to weather much longer the financial crisis in these multi-employer pension plans. We have absolutely no control over the negotiation or setting of benefits or contributions in these plans and, as mentioned earlier, it is difficult for us to even obtain timely and accurate financial information from them. The trustees are not accountable to us. They represent either the Teamsters union or one of the major national companies that pay their salary. We also lack the leverage at the collective bargaining table of those national companies. In sum, we cannot reform or change these plans from within, or at the bargaining table. We need your assistance.

THE DETERIORATING FINANCIAL CONDITION OF THE MAJOR TEAMSTER PENSION PLANS

Much of the discussion in this testimony focuses on the Central States pension plan. That is because all the Alliance members participate in that multi-employer pension plan and it is the second largest Teamster pension plan with over $17 billion in assets. However, financial information on several other significant Teamster plans, which are also severely underfunded or at risk, is attached to this testimony. [Exhibits 2–4]. Central States may be one of the worst plans, but it is not alone.

The deteriorating financial condition of these plans is widespread because no new employers are willing to join and be exposed to withdrawal liability. Deregulation of the trucking industry and the passing of MPPAA in 1980 commenced the slow, but steady, decline of the unionized trucking industry. Many unionized employers have ceased operations and the Teamsters have lost over 100,000 jobs in the freight sector. This in turn has dwindled the contribution base of these plans.

For example, there are now more retirees drawing pensions from the Central States plan than active workers on whose behalf employers are making contributions. [Exhibit 5]. The plan is experiencing a 2 percent decline annually in the contribution base. With more and more workers reaching retirement age, the situation worsens each year. The average age of a union truck driver is approximate 55 years old.

Consequently, the Central States pension plan has an annual negative cash flow of over $1 billion. It must rely on the returns on its investments each year to cover this expanding shortfall in revenue. For a while the rapid increases in the stock

market masked these problems. But the stock crash in 2001 caused these plans assets to plummet and they are unlikely to change in the near or long-term future. The Central States plan, which reached a funding deficiency in 2004, is experiencing another bad year in 2005. It is projecting another $1.2 billion loss; for the first quarter 2005, it lost $461 million and had a negative return on investments.

Since the passage of the Multi-Employer Pension Plan Amendments Act of 1980, there has been a steady decline in these multi-employer plans. There were approximately 2,200 plans in 1980 and fewer than 1,700 remained by 2003. Only five new plans have been created since 1992. The number of active participants in these plans has decreased by 1.4 million since 1980. Thus, Central States is not alone in this financial struggle; it is however on the front burner having already reached a funding deficiency.

The seven largest Teamster plans were collectively underfunded by $16–23 billion in 2002, depending on the method of calculating the assets. In 2003, the Central States plan alone was underfunded by $11.1 billion. It has been estimated that underfunding in this plan has further increased in 2004 to $15 billion. Many of these other plans are as financially strapped as the Central States plan, based on the 2002 data. These Teamster plans account for one quarter of the $100 billion in total multi-employer pension plan underfunding.

However well intentioned, the changes made to the pension laws in 1980 have exacerbated the financial problems of these plans rather than strengthened them. These plans cannot continue to exist without new employers and more active participants. MPPAA shut the door on future participation by imposing withdrawal liability on all employers for plan underfunding. The problems confronting these multi-employer plans are systemic and they will not solve themselves.

It is both shortsighted and patently unfair to propose an alleged solution which could force smaller contributors out of business rather than a solution that encourages them to grow their businesses, increase union jobs and continue to make plan contributions.

THE IMPACT OF PLAN UNDERFUNDING ON SMALLER BUSINESSES

Underfunding in multi-employer plans creates serious financial problems for all employers in the plans, but especially for smaller firms that lack access to capital that is available to publicly-traded companies.

First, there is a cash flow problem when a plan, like Central States, reaches a funding deficiency. The employers, by law, are obligated to pay for this deficiency to put the plan back within the minimum funding standards of ERISA. Compounding the funding deficiency payments are excise tax penalties that are imposed.

Exhibits 6–8 illustrate how the combination of additional contributions and excise tax penalties would destroy the finances of a smaller company with 100 employees. A funding deficiency of approximately $400 million, an amount consistent with the Central States plan's estimates for 2004, would increase this company's pension contributions by 40 percent. It would incur an additional 5 percent excise tax penalty that goes not to the plan but the general treasury and therefore does not help plan solvency. This company may be able to survive the first year of the funding deficiency. However, in the second year, it will be forced out of business because the additional contributions then would increase to 135 percent of current contributions to the plan, and the excise tax penalty would be an additional 100 percent of the prior year's deficiency.

The second way in which plan underfunding harms employers is when a withdrawal from a plan occurs. While a cessation of operations is the most common way in which withdrawal liability results, it can also arise through a change in operations, a terminal shutdown, a decline in union workers, involuntarily by strike or decertification of a union by the employees, expulsion by the pension fund, or disclaimer of continued representation of the bargaining unit by the union.

The financial impact of withdrawal liability is now overwhelming. The amounts of liability, which are calculated on a pro-rata share of underfunding, now far exceed the ability of most companies to pay; it exceeds their entire net worth. The withdrawal liability of Standard Forwarding for 2004 is $20 million which is well beyond our means. Bankruptcy would be our only recourse.

For the MEPA Alliance members, the costs associated with withdrawal liability that would be owed the Central States plan can be as high as 5 times their net worth and 10 times the profits in their most profitable year.

While the MEPA Alliance has focused on the harsh financial reality of underfunding on employers, ultimately it will impact the employees' pensions and the Federal Government through the PBGC. If these plans cannot regain solvency, they face ter-

mination. The employees are only guaranteed payments of approximately $1,000 per month, which is far below the $3,000 a month maximum benefit under the Central States plan. Therefore, they could lose up to two-thirds of their benefits. The PBGC would be obligated to pay that amount, if plan assets were insufficient.

Therefore, employers, employees and their Union representatives, and the Federal Government all have a vested interest in solving this problem promptly.

THE NEEDED CONGRESSIONAL REFORMS

1. Full and Timely Disclosure of Plan Financial Information

The time is long overdue for complete, timely and accurate disclosure of the key financial information by these plans. The financial condition of the Central States plan has been a guarded secret, with only the union and four major transportation companies privy to the most up-to-date information.

Under current law the multi-employer pension plans provide annual reports almost 9 months after the end of the current fiscal year. Therefore, the Central States plan will release its 2004 information in September of this year. There is simply no reason why this annual report information in the Form 5500 cannot be disclosed much sooner, such as within 3 months after the end of the fiscal year. The key financial information, including the annual actuarial reports, should be released to all participating employers and employees, by written communication or posting it on the plan's Web site. The Alliance members also believe that these pension funds, like mutual funds, should be required to provide quarterly updates. These updates are now provided by the Central States plan to the court overseeing the fund, so this would not be a new or burdensome requirement.

Consideration should also be given to mandating a change in the make-up of the Board of Trustees, which is now controlled by the union and largest transportation companies. A rotation of employer representation, to allow for participation by smaller employers, may be appropriate.

2. Repeal of the Federal Excise Tax and Current Funding Deficiency Rules is Essential

Under current law, the combination of Federal excise tax penalties and additional mandated payments under the minimum funding standards will drive smaller trucking companies out of business within 1 to 2 years. They simply lack the cash to pay an additional 135 percent of contributions. These rules should be replaced with new reorganization procedures that apply to any plan that is severely underfunded or at risk of becoming severely underfunded. A severely underfunded plan should be defined as one that has a funding ratio of assets to liabilities of 65 percent. An at-risk plan should be defined as one with a funding ratio below 80 percent. It is simply imprudent to wait for a plan to become severely underfunded, or near terminal, before remedial, reorganization measures are imposed.

While the Alliance members support the general framework of the legislative proposal made by UPS/Teamsters and the national LTL carriers, safeguards need to be built into that proposal to protect smaller employers. Under their proposal, when a plan goes into reorganization, additional contributions can be imposed on employers up to 10 percent of the existing contribution rate of the employer. This 10 percent cap remains until the next collective bargaining agreement is negotiated. At that time, the pension plan will become involved in the collective bargaining process by submitting schedules to the parties based on the funding needs of the plans. The pension plan could submit a schedule that requires a 40 to 100 percent, or more, increase in pension contributions that a smaller employer cannot afford to pay. Under their proposal, the employer could be expelled from the plan, withdrawal liability then would be imposed, forcing bankruptcy upon the company. This unprecedented delegation of power to the plan to impose additional contributions needs to be restrained for the good of all employers. The Alliance members believe that a cap on additional contributions should be set at 15 percent above the rate under the prior collective bargaining agreement.

3. Re-establishment of Limitations on Employer Liability

Nothing could be more unfair or more anti-business than a law that provides that even though you have made all of the pension payments agreed to with your union, you still can lose all of your company's assets if a plan becomes underfunded resulting from the actions of others outside your control. Essentially, the changes made to the Federal multi-employer pension laws in 1980, made all contributing employers bear the burden for the pensions of workers who never performed any jobs for their company and for the pension obligations of their competitors who have gone out of business. That violates the most basic American principle, that a person and business should be allowed to prosper from the fruits of their labor.

The Alliance members believe that Congress should restore the law in effect prior to 1980 that limited the liability of an employer in an underfunded plan to 30 percent of the employer's net worth. Ideally, the concept of joint liability of all employers for plan underfunding should be repealed. It has only served to deter new employers from joining these plans and it has not improved the financial condition of the plans which was the main rationale behind the concept of withdrawal liability.

Even unions recognize this plight. As stated as early as 1982: "The International Ladies Garment Workers Union hopes the PBGC will permit its multi-employer plan to exempt the small entrepreneur who simply wants to sell his business and retire. 'He's tired, he wants to quit or he has a few bad seasons and feels another bad season would wipe him out,' observes the union's president, Sol Chaikin. 'My own feeling is that it would be cruel and unusual punishment for our union pension fund to demand his unfunded liabilities going back 20 years. That would leave him without a penny.'"

The plans will tell the subcommittee that they generally only collect 10 percent of the amount owed when an employer withdraws because few assets are left when an employer ceases operations. The PBGC has testified that they collect a comparable 10 percent amount when a single-employer goes into bankruptcy.

Just as the Federal Government has found it intolerable that 90 percent of these costs in single-employer plans are passed on to the PBGC, the employers in multi-employer plans find it intolerable that they are made to bear this huge expense. In fact, they can no longer shoulder this cost. No company should have all it's assets on the line for an obligation it never made to workers who were never employed by them. The 30 percent net worth standard needs to be restored by Congress.

4. Withdrawal Liability Rules Should Be Eliminated Not Made More Onerous

The current law is extremely onerous on contributing employers to multi-employer pension plans. First, they are made liable for plan underfunding that they had no part in the making. Then, they are required to pay the withdrawal liability assessed by a plan before they have the right to contest it in arbitration. Moreover, the plan's determination and calculation of withdrawal liability is presumed correct until proven otherwise by the employer. It is patently unfair and contrary to normal rules of American jurisprudence to require employers to pay this alleged liability before the liability is even established.

Likewise, the fund can sue all the affiliated companies and individuals that have majority ownership interest in the participating company and affiliated companies and seek to make them jointly liable for the withdrawal liability. All employers would be well served by repealing these "pay now and dispute later" rules and controlled group liability regulations.

Further, it is wholly inappropriate to tighten the withdrawal liability rules, as proposed by UPS/Teamsters. No company should be exposed to withdrawal liability when it uses owner operators, independent contractors or third party leasing companies to perform transportation services at its facilities. That is contrary to Federal labor law and labor policy. It will only harm trucking companies and their customers. It will provide a basis for these plans to expel employers and drive them into bankruptcy.

The trucking industry rule should also not be repealed. This rule is one of the few beneficial exceptions to withdrawal liability that Congress created in 1980. More trucking employers will only enter these plans if they have an assurance that they will not be on the hook for past underfunding. Congress must resist attempts to tighten the noose of these withdrawal liability rules.

5. Pension Promises Should Be Made Only When They Can Be Paid

In 1992, the PBGC became aware that the alarming rise in pension plan underfunding was due in part to benefit increases that could not be sustained by the income to these plans. It is neither fair to the employers nor to the employees to increase benefit levels that cannot be sustained by the contributions to the plan and the return on the investments. Yet that is what has occurred. Consequently, these plans have had to make recent changes to future benefit accruals and in other areas permitted under current law.

What is needed is an objective standard that governs future benefit increases. In the past, bills have been introduced in Congress that would allow a plan to increase benefits only when it is at least 90 percent funded. Such an approach makes sense and the Alliance members support it to ensure that future benefits can be paid. Otherwise, they are only false promises that increase the withdrawal liability of employers.

6. The Need For A Congressional Study On Long Term Solutions To Plan Underfunding

While all the above reforms are vital to the short-term viability of these plans and their contributing employers, there remains a need for Congress to address the significant past underfunding in these plans. The Central States plan has $11–15 billion in accumulated underfunding. Our recommended reforms will prevent this plan from becoming worse, but it will not solve the ills created in the past.

At best, we project that the plan, which is now about 65 percent funded, may become 75 percent funded with our suggested changes. The reason for this modest improvement is that cost of the benefits to the retirees, who have no contributing employer, is consuming all the contributions to the plan, a situation that is getting worse each year. It is unsustainable over the long-term. We believe that an objective study is necessary to remedy the problem. A Congressional study commission is an appropriate method to develop meaningful and fair solutions for employers, retirees and the Government. We therefore ask that Congress fund such a study and require a report back, with recommendations, within 1 year.

CONCLUSION

The Alliance members recognize that defined benefit plans, both single-employer and multi-employer plans, once were the pillars for creating a sound retirement income for workers in this country. The sad reality today, however, is that countless numbers of businessmen and women will not offer them to their workers because of the onerous rules and liabilities that attach to them under ERISA and MPPAA.

The basic elements of opportunity and incentives are missing from the equation. Meaningful reforms of the law, as discussed above, can revitalize these plans. Without change, the plans will continue to decline in numbers, in financial strength and as retirement vehicles for workers.

The Alliance sincerely appreciates the opportunity to address this important issue with the Senate Subcommittee on Retirement Security and Aging. We will do all we can to assist you in this difficult, but critical, decision making process. This is the single most important legislative issue confronting unionized trucking companies. It is not an overstatement to say change is necessary for the very survival of the smaller, family-owned, union trucking company members of the Alliance.

[Editors Note—Due to the high cost of printing, previously published materials submitted by witnesses are not reprinted. Exhibit 1 can be found in committee files. See prepared statement of Mr. Lynch for Exhibits 2–8.]

Senator DEWINE. Very interesting comments from all of you. Let me ask the whole panel this question. We have consistently heard that trustees of multi-employer plans will not produce information about funded status, projections about shortfalls, other relevant information that contribute to an employer's need for planning purposes, and participants really need to be confident about their retirement plans. How do you respond to these criticisms about multi-employer plans? Are some plans more secretive than others, and are they the exception rather than the rule? Mr. Ward?

Mr. WARD. I can only speak with regard to Central States' plan, but it is very difficult to get information from them. Our withdrawal liability for a particular year, for instance, is not available until around September of the following year, 9 to 10 months after the year is closed. Likewise, finding out that it is in severe trouble was not information that was shared until it was almost too late.

Senator DEWINE. Mr. Noddle?

Mr. NODDLE. Generally almost all the plans are difficult to get information from, but it is also the timeliness of them. It takes about a year to 2 years to understand the exact financial condition of any of the plans, and in this day and age, with the technology that we have, there is no reason that there should not be quicker information and more transparency in these numbers.

Senator DEWINE. Mr. Lynch?

Mr. LYNCH. In my testimony I indicate that the members of my association by and large do have trustees on these plans, and con-

sequently the thought is that they would have more access to information. The fact of the matter is, that is marginally true. It is a difficult process, and I agree with the other witnesses, that in our view it is really an issue of timing. Waiting for information that is a year and a half old—and let us face it, if you have good news to report, you are probably not going to wait until the very last date of the filing. If you do not have such good news to report, you will. And typically that results in a situation where some of the steps that could be taken are perhaps a little too late.

Now, I am a trustee on a plan. In response though on the other side, from the trustee perspective, I am a trustee on a plan, and the day I was sworn in, if you will, the first question I got was, you have your trustee liability insurance paid up, right? You are constantly reminded by the attorneys in these plans of your fiduciary responsibilities and the amount of information, the type of information you are allowed to discuss, and frankly, not discuss if it has not been publicly disclosed.

Senator DEWINE. Mr. DeFrehn?

Mr. DEFREHN. I guess my experience is a little bit different than what the others have had. I have had extensive experience with dozens if not hundreds of plans over the years, and the simple fact of the matter is that the timing on releasing of information, particularly withdrawal liability, is in part a function of the way that the code is designed and the information that has to go into the complex calculations that take place.

On the other hand, for the most part, I think that you will find that the willingness of most plans to share information that is available is fairly high. There are notable exceptions to that. One thing that should be noted by the committee is that in last year's Pension Funding Equity Act, there were significant disclosure requirements added that will become effective at the beginning of next year, and I think that a large part of the concerns of most contributing will in fact be remedied because it requires additional information on current financial status to be provided to them as well as participants and the sponsoring unions.

Senator DEWINE. Mr. DeFrehn, let me ask you another question. What actions have been taken to stabilize their funding?

Mr. DEFREHN. The funding of?

Senator DEWINE. Multi-employer plans.

Mr. DEFREHN. If you look back over the years, I guess I try to take a historical perspective on withdrawal liability. I would agree with the comments that everyone has made here, that it is both a good thing and a bad thing, and I think both parties look at it that way. In some ways it has created financial burdens for smaller employers, as it has for larger employers, and there is certainly, room for improvement there.

On the other hand the fact that there is withdrawal liability, unfunded liabilities, has caused the trustees of the plans to adopt more conservative funding policies over the years, and if you look back to the funding levels of most plans, most multi-employer plans, it was quite high. In 1999 the average funded position of multi-employer plans was 97 percent. In fact, it caused—the funding level of those plans caused plans to have to adopt benefit improvements they would not otherwise have in order to protect con-

tributions to the deductibility of contributions made by contributing employers.

So the problem is simply that there is a disconnect here between the funding levels, the reliance of mature funds on investment income, and what has happened over the last 3 years in particular.

Senator DEWINE. Senator Mikulski?

Senator MIKULSKI. Thank you very much, Mr. Chairman. First of all, thank you for this selection of witnesses. I think we have covered quite a broad base. Mr. Noddle, my father was a small grocer. He was a member of the Independent Grocers Association before the family closed its business in the late 1970s. So we have an understanding. I think what has been instructive for me is how many different plans many of you have to be members of, and, Mr. Ward, you have your own challenges as a small business, and just complying with this must be really a challenge. And for the men in the freight forwarding business, you got rising gasoline prices, you got rising pension costs, you got rising heartburn.

[Laughter.]

I see certain consensus emerging: No. 1, more transparency in the process; No. 2, the right to know in a timely way; No. 3, some type of risk assessment because one size does not fit all, and really a prevention mechanism so there is the Green Zone, regardless of how you parse it, Mr. Noddle, you have one viewpoint, Mr. Lynch, you have another, but by and large you are talking about an early warning system; and then a rating of the Green Zone, Yellow Zone and Red Zone. Would you say that those are the four or five items on which there is a consensus around which we could begin to build some of the first—kind of first tier reforms. Mr. Lynch, would you say that is the consensus?

Mr. LYNCH. I would agree. I would add maybe one other one, and that is the requirement that plans really do develop a funding plan for the next 10 years to show improvement in the funded status of the plan. It would almost seem, why do we have to have a law to do that? But in many cases, until a plan hits a severe funding problem, there is really no requirement for that so——

Senator MIKULSKI. Is that in the reforms that have been recommended through the various——

Mr. LYNCH [CONTINUING]. Yes, they are.

Senator MIKULSKI. —things that I have read, the so-called 10 year amortizing?

Mr. LYNCH. That is another issue, but a 10 year plan that shows an improvement in the funded status of the plan.

Senator MIKULSKI. Mr. Noddle, Mr. Ward, were those the consensus items, or did you have another item to either disagree—we welcome any disagreement.

Mr. NODDLE. I would just offer two things, Senator. First of all, yes, I think those are the basic pillars of a very cooperative agreement that most parties I think would adhere to. The thing we feel very strongly about is that there should be certain measurable, quantifiable benchmarks along the way, and that should be a component of it. If it is left to judgment at times the outcome might not be strong.

Senator MIKULSKI. You mean real criteria for Green, Yellow; is that what you are talking about?

Mr. NODDLE. Yes, and within those also very clear benchmarks within those zones. The other concern that we have is that in the Yellow Zone, we think a lot of the plans, a lot of the ideas that are being focused on the red areas or those under 65 percent. What we were trying to focus on in those plans in the 65 to 80, not that the under 65 does not need a lot of attention here, but we want to get ahead of this. We do not want these to become—once you are faced with a crisis it is almost too late.

Senator MIKULSKI. Yeah. So you get late information, which means that they have been in the Red Zone or Yellow going to Red, but you are waiting 18 months for dated information, which you know because it is dated and not good. Then you are really into a bailout. And then the good-guy employers, from what you are saying, are left holding the bag for everybody else. And so who in the heck wants to get into this. I mean is that it in a nutshell?

Mr. NODDLE. Yes, it is. And within the plan, if you are in a Yellow Zone plan and you create a plan over a long period of time, you would have benchmarks within that plan that both labor and employers would understand what those benchmarks are, and so that the collective bargaining process then could go forward knowing what those benchmarks are.

Senator MIKULSKI. And everybody, including as the union or the employer comes to the table, you would then have accurate information so you know that when you are bargaining what essentially the situation is, the adequate. What is the fiscal situation? In other words, you can bargain for a pension of $50,000 a year, but if there is only a pension funding for 38——

Mr. NODDLE. Senator, there should be no debate over what the numbers are. The debate should be over how to solve the problem.

Senator MIKULSKI [CONTINUING]. That is exactly right.

Mr. NODDLE. Not what the numbers are.

Senator MIKULSKI. Right.

Mr. Ward? Is that, remember what I said, transparency, early warning system, the right to know information in a timely way, and precise, and then some type of rating system.

Mr. WARD. Yes, I would agree completely with that. I would maybe add to that the deficiency, funding deficiency penalties and payments that kick in at——

Senator MIKULSKI. That excise tax issue you raised?

Mr. WARD [CONTINUING]. Yes. I think we would all agree that we also have to deal with that. In fact, Congress did deal with that temporarily a couple of years ago, so that is one——

Senator MIKULSKI. And that is one of the issues where you are doubly penalized, so therefore if you have already gone Yellow to Red or you are trying to get out of Red, if you trigger these taxes it keeps you further in the hole, am I correct?

Mr. WARD [CONTINUING]. In fact, they are so onerous that they would bankrupt our company in a short period of time, so yes.

Senator MIKULSKI. My time is up, and the chairman of the full committee is here. In my second round I am going to ask how many Government agencies do you have to deal with in compliance, and does that make any sense, or is that another reform?

Mr. WARD. Thank you.

Senator DEWINE. Chairman Enzi.

The CHAIRMAN. Thank you, Mr. Chairman. I want to congratulate you and the ranking member on your dedication and diligence and understanding of this issue and the work that you are doing on it. Our charge was quite limited, but obviously needs to be expanded to take care of a number of the problems that we have in these areas, and congratulate you on the witnesses that we have today.

[The prepared statement of Senator Enzi follows:]

PREPARED STATEMENT OF SENATOR ENZI

Today's hearing will focus on two key issues in the defined benefit world that are crying out for reform: hybrid single-employer plans and multi-employer pension plans. I think it is safe to say that every member of this subcommittee, and every member of the full Health, Education, Labor, and Pensions Committee is committed to the stability and strength of the defined benefit system. Today we will look at ways to promote stability and strength for hybrid and multi-employer pension plans.

In the view of many, hybrid pension plans, such as cash balance and pension-equity plans, are the last best hope for preserving the single-employer defined benefit system. Quite frankly, defined benefit plans are in competition with defined contribution plans. The lower costs, risks, and frustrations that are presented by 401(k) plans have contributed to the accelerating decline in the number of traditional pension plans. Hybrid plans were devised as an alternative to outright termination of a traditional pension plan followed by a switch to a defined contribution plan. Hybrid plans provide portability to workers who change jobs while retaining the risk of investment declines on the employer.

The legal status of hybrid plans has been called into question in recent years. The principal criticism of hybrid plans is that they "cut benefits" of older workers. That allegation is incorrect. As we all know, a cut-back of vested benefits is specifically prohibited under section 411 (d)(6) of the Internal Revenue Code. The penalty for cutting back an accrued vested benefit is plan disqualification. At this hearing we will hear arguments from the AARP that these plans are age discriminatory, and we will hear from two other witnesses why they think they are not. The witnesses will tell us what reforms are advisable and necessary to clear up this issue.

We will also hear of the financial crisis facing some of the multi-employer plans. Multi-employer pension plans provide essential retirement security to 9 million workers, yet there is much we do not know about these plans. Both labor and management are coming to Congress seeking reforms to the current system to empower them to get the financial affairs of their plans in order. Billions of dollars are at stake and the survival of hundreds of small and medium-sized companies may be in doubt, depending on the decisions Congress makes. It is essential that we understand the causes and scope of the problem and ensure that we have the information and transparency to prevent such crises from sneaking up on us in the future.

I am pleased with the many bi-partisan discussions that Senators and their staffs have been having in the last 3 months over the details of comprehensive reform of the single-employer defined

benefit system. I fully anticipate that the HELP Committee will be able to produce a bill this summer before the August recess. The issues raised today, assuming consensus can be reached, may also be included in the package of reforms that goes to the Senate floor.

Senator ENZI. I will get into some fairly specific questions.

Mr. Lynch, in testifying before a House subcommittee last year, you stated that serious consideration should be given to whether additional procedural or legal controls over the management of the plans could prevent serious funding issues. Something as simple as imposing funding policy guidelines that mandate clear targets for the plan's unfunded liability. Your suggestion of imposing funding policy guidelines caught my eye. I realize that your coalition has rejected the benchmarks for the Yellow Zone, but are those benchmarks not the equivalent of imposing funding policy guidelines that you advocated last year?

Mr. LYNCH. Yes.

[Laughter.]

Mr. LYNCH. I guess the easiest way to explain this from our vantage point is there is clearly a need to have not just simply: we hope you are going to do a better job on the one hand. On the other hand we cannot have criteria that is so stringent that the plans and the trustees simply cannot meet them, or in order to meet them there would have to be such draconian increases in employer contributions, where you would get back to putting in jeopardy a lot of the smaller contributing employers.

So we are walking a somewhat careful line here. I think it is hard to argue against, and I certainly testified in favor of just such a plan. But that plan cannot be so stringent as to strangle these plans before they have an opportunity to actually get back on sound financial footing.

The CHAIRMAN. Thank you.

Mr. DeFrehn, your Red Zone proposal mandates a minimum participation accrual rate of 1 percent. That puts a floor on how much the trustees can cut benefits even temporarily. I note that another witness is asking for a ceiling on contribution increases, at least for small businesses. How can the plans ever get out of financial trouble if Congress takes options off the table?

Mr. DEFREHN. One of the concerns of the coalition and of the multi-employer community generally, is that by eliminating future accruals all together, the active employees who actually fund these plans from the deferral of their wages as a collective bargaining agreement is reached, there is a wage package that is settled upon. The parties then discuss how that wage package gets allocated. A portion of it may go to health benefits, a portion to pensions and some into the wages. If you get to the point where the future accrual for active employees is eliminated all together, you eliminate the incentive for them to want to have a portion of their wages go into a plan for which they get no future benefits. So we believe strongly that it is important to not take the entire benefit away and that there should be a floor on that.

With respect to Mr. Ward's comments about the cap on withdrawal liability, that is an issue that affects plan—participating employers who leave the plan at a time when there are unfunded liabilities. And unfortunately, withdrawal liability creates no win-

ners. But someone has to pay for those benefits. It is either going to be the employer who made the promises in the first place in agreeing to participate in the plan, or it is going to be the participant through reduced benefits, or it is going to be the PBGC, and I believe at this point the PBGC is off the table, and the participants, while our proposal suggests that perhaps some ancillary benefits could be reduced when the plan is facing imminent danger, we do not believe that benefits should be invaded at a point where the plans are relatively healthy.

The CHAIRMAN. Have you done any economic modeling on the FMI Yellow Zone proposal?

Mr. DEFREHN. Yes, we have. Two plans, I can give you some examples. One——

The CHAIRMAN. Would you mind sharing that with the committee?

Mr. DEFREHN [CONTINUING]. Sure.

The CHAIRMAN. Because then we can get into more detail than we could through an answer here.

Mr. DEFREHN. Certainly we can get you the details.

The CHAIRMAN. Thank you.

Mr. DEFREHN. Sure.

The CHAIRMAN. Mr. Noddle, what is your concern if only the Red Zone provisions were to be enacted?

Mr. NODDLE. Well, Senator the way we look at it, the Red Zone is a crisis situation and it has to be managed as a crisis. The Yellow Zone is a pending, looming problem that if not addressed will become a Red Zone crisis. So simply I cannot think of any reason why we would not want to get more transparency, more early warning into these plans, have a look into these plans to see so that the trustees and the collective bargaining process can sit down, not debate over what the numbers might or might not be, and say, we have a long-term problem here. How do we protect the retirement benefits for the people that we have promised them to? So let us do this over a longer period of time.

That to me is just prudent. We do that in every other part of our business every single day in trying to anticipate what the future is going to be, how do we fund it, how do we react to it? I do not know why this would be any different.

The CHAIRMAN. Thank you. My time has expired.

Senator DEWINE. Senator Isakson?

Senator ISAKSON. Let me take a pass for now.

Senator DEWINE. Sure, sure.

Barbara?

Senator MIKULSKI. I will pick up on that question I said I wanted to ask, and start with you, Mr. DeFrehn. When I asked for the consensus, I am sorry, I advertently overlooked getting your opinion, and share it. Here is my question, what are the agencies involved that you all face in compliance? Do you have essentially a one-stop shop? Are you dealing with a multiplicity of agencies? Which takes us to the compliance. Then what are the agencies, or are these agencies involved in helping with this so-called warning system and the enforcement of this? And what recommendations do you have and what generally has been the cost of your compliance? I mean those are fairly meaty, but it sounds like while you are try-

ing to run a business, be a labor union and bargain in good faith for both your workers, but understanding you need a solvent company to be able to work for one, it just seems to be layers and layers of complexity, where you all cannot get what you need to do the job, and then I have a feeling you are dealing with about three different agencies within the Government.

By the way, I want to thank you for two things. One, testifying today, but not dumping, not dumping the problem on us, telling us to come up with the solutions. Obviously, you have done a tremendous amount of work on coming up with viewpoints, even if they disagree, there is consensus, and also for not dumping the liability. So we appreciate this, and therefore I'm going to have this partnership.

Mr. DeFrehn, could you help me with these issues related to Government and governance?

Mr. DEFREHN. Sure. The three Government agencies that we work with most are the Department of Labor, the Internal Revenue Service and the Pension Benefit Guaranty Corporation.

I think your assessment of how complex and multilayered the process is is accurate. Unfortunately, it is not terribly responsive to the kinds of problems that we address and I mentioned in my oral testimony about making sure that plans that are subject to circumstances beyond their control be able to take advantage of the relief mechanisms that the law provides. Certainly over the past several years, the Internal Revenue Service in particular has been deficient in terms of its ability to respond to requests from plans that are facing funding deficiencies through the existing remedies under Section 412(e) of the code. There are at the present time about 30 applications, some of which have been sitting there for as long as 2 years.

Senator MIKULSKI. Wow.

Mr. DEFREHN. And the Agency has not taken action on those applications. So that the parties, the contributing parties have an idea as to whether they actually do have a funding deficiency or not. Those are applications that would permit the plans to have an extended amortization period for their liabilities.

Senator MIKULSKI. Mr. Lynch? We could just go down.

Mr. LYNCH. There is not a lot to add except that when, as members of the committee know, when we were working on that short-term relief bill 2 years ago, a 1½ ago, there was a fairly strong focus on the single-employer problem and the interest rate issue. We were generally viewed as the skunk at the picnic I guess coming along.

Part of the difficulty we have with some of these agencies is I think the plans have by and large worked very well, and so there has not been a lot of attention paid to them, and consequently, I think there was a certain reluctance on the part of some of these agencies to really step forward and say, this is what we think needs to be done to address the problems of multi-employer plans.

So as a corporate representative, and I am generally loathe to be suggesting more Government involvement, but I do think it would be useful for agencies like the PBGC—and I know they have created a new department over there, a reorganization, and the new department to look at the multi-employer issues. But I think that

is very important, that they get a better handle on what the issues are.

Senator MIKULSKI. One of the things that I would hope, and then there would be a follow-up conversation after this hearing is, do we need one agency that is the primary one-stop shop? No. 2, is the pension guaranty really coming in when people have been not only in the Red Zone but it is when Red Zones are almost irredeemable and on the verge of us assuming liability? And then what is the role of Department of Labor in this? Mr. Noddle, do you have comments?

Mr. NODDLE. The only one, Senator, that I would add that has not been mentioned is that as a public company that we have to deal with is the whole area of finance, the GAAP accounting and FASB and that is a whole other arena which we have to assess our liabilities——

Senator MIKULSKI. Senator Enzi's area as Mr. Accountant here.

Mr. NODDLE [CONTINUING]. And they may not always be in sync also with the way certainly the plans or trustees look at things. So the only thing that has not been mentioned that I would add is that.

Senator MIKULSKI. So we have at least some policy recommendations that are at least the beginning of a consensus. Then we get into both compliance and enforcement, in which they should be a tool to resolving the problem before there is bankruptcy and insolvency, or essentially the dumping of the liability onto the pension guaranty. You see what I am trying to get at? Good policies and then a way where good guys who want to participate, good-guy companies that feel the Government is on their side, not just triggering excise taxes and forcing small businesses like you, Mr. Ward, into bankruptcy.

Do you have any thoughts on this? Because you are a family-owned business, and very sympathetic to this.

Mr. WARD. Thank you very much. I could not add much at all to how you have described the complexity in dealing with various Government agencies and I do like the idea of a single point of reference, so to speak, that we could go to in dealing with these kinds of issues, and particularly gain some help.

But if I could give you some perspective as a small employer on this particular mess that we are in right now, and the thing that concerns me is I look—I probably do not look at it like they do, at the level of detail. I run a small business. I am trying to grow a small business. I am doing it with union employees. There is a lot of pride involved in that aspect of what we are doing. We are one of the last of the Mohicans really in terms of small union carriers that are growing. Mind you though, where is the incentive, when on paper our withdrawal liability exceeds the entire net worth of our company? From a business case standpoint, there is no business case. Without pride, this business should be shut down.

If there is some opportunity though at some point to limit the amount of withdrawal that exists out there, I believe at least the current carriers that are there would find incentive to continue to operate and continue to push forward.

Senator MIKULSKI. So that is the incentive thing to keep people engaged in this multi-employer.

Mr. WARD. Without it, put yourself outside the fund as an employer that the union would maybe organize, and they would bring you to the table and ask you, "Would you like to participate in this multi-employer fund?" Never in a million years would you do it. You would take your nonunion company down through a strike if need be to avoid the withdrawal liability. There is absolutely no way any new employer is going to come into this fund because of that disincentive that exists out there. And it exists as a current employer, and I believe that is why you do not see more people like me growing union businesses.

Senator MIKULSKI. Thank you. I appreciate that.

Thank you.

Senator DEWINE. Senator Enzi?

The CHAIRMAN. I would defer to Senator Isakson.

Senator DEWINE. Senator Isakson?

Senator ISAKSON. I do have one question, and I apologize for being late, I have just come from an hour of the Finance Committee hearing on single-employer pension benefit programs.

This is a very complex issue, but I would like to hear each one of you discuss one aspect. There are two schools of thought. One school of thought is to extend the amortization of liability to give companies in trouble a chance to have the best of both worlds, and that is not be forced into bankruptcy and still be able to meet their liability without the liability of the fund going into pension benefit guaranty.

The other is the short window recovery, meaning if you have an unfunded liability of $9 million, it is 3 million over 3 years to make it whole, whereas the more liberal approach might be to let you amortize that over a longer period of time. I think I heard Mr. Lynch say—and it may have been Mr. DeFrehn, I am not sure—about the threat if you had this short-term window, required cash contribution, of how many companies it would force into bankruptcy, that is similar to exactly what the aviation industry faces today on the single-employer plans.

If you all could just help me for 1 minute, and you probably already addressed all of this, but just give me your response to that, what you think is preferential, I would like to hear it.

Mr. DEFREHN. Amortization extensions can help, and actually we are a part of the proposal that was offered in the earlier versions of the Pension Funding Equity Act last year for plans.

The key though is that the extension be tied to a reasonable interest rate, and that seems to be part of the problem that the IRS has with acting on the 412(e) applications. I guess that is my only comment on that.

Mr. LYNCH. I think the challenge there is that you want short-term remedies to address short-term unexpected problems, market downturns, unexpected downturns. What you do not want are remedies that mask what is a much deeper problem and I think that is what we all have to wrestle with.

Central States, large pension fund, Central States cut their accrual rate from 2 percent down to 1 percent, but they amortized that change over 30 years. It is going to take them a long time to get the benefit in terms of all the actuarial calculations of that change, and we would like to see those things, not only the cuts,

but also any improvements to be amortized over a shorter period of time, and we think that makes a lot of sense.

Mr. NODDLE. There is no simple solution, one single resolution that is going to solve this problem. These are long-term plans with long-term funding, and in order to solve this problem we have to look at it over longer perspective, and not everybody is going to retire tomorrow anyway.

You know, one thing that has not been mentioned that I am sure that you realize, that I did not realize, frankly, till I got deeper into this issue, in the year 1999 and 2000, for example, funds were required to increase their benefits because their investment returns were high enough that there was an overfunding status in these plans. The way the regulations are written, if you do not increase your benefits, you lose your tax deductibility for the money you put in because you are overfunded. Rather than putting that money away for a rainy day, the plans and the trustees were forced to increase benefits. These are the kinds of things I think that we have that we have to clean up in these plans. And it takes a long-term view of the plans to resolve all those things.

Thank you.

Senator ISAKSON. Thank you.

Mr. WARD. Senator, I do not think I could add much to that. I would just say that we focus mostly on the plan that Mr. Lynch represents, the proposals that he has made. With regard to those issues, I think we are very much in acceptance of those.

Senator ISAKSON. Thank you.

Thank you, Mr. Chairman.

Senator DEWINE. Senator Enzi?

The CHAIRMAN. I have a couple more questions here to get an understanding. Mr. Noddle, when you go into collective bargaining on one of these plans, do you bargain for benefits or for contributions? How do you know if the benefit you agreed to will cover the benefits that the trustees have promised? Why are the contributing employers on the hook for promised benefits if they did not promise benefits?

Mr. NODDLE. We do not bargain for and negotiate for benefits. We negotiate for funding levels, and this is what comes into the transparency issue and the lack of timely information. If all the information was clearly available on a timely basis to all parties, then the collective bargaining process goes forward in a much more quality way in terms of dealing with this thing.

We negotiate funding levels, and then the trustees make decisions on what kind of benefit levels there will be. That is why the transparency issue and the early warning are so critical to this, so that we can sit down at the table, intelligent on both sides of the table, no dispute over what the numbers say, and one expert says one thing and another expert says another thing. We should have a common information transparency, and we say: Here is our collective problem; how do we solve this? And we are going to get such higher quality resolutions to our agreements if we are able to do that.

The CHAIRMAN. Thank you.

Mr. Ward, along that same line of timely and accurate information, in your written statement you wrote: the financial condition

of the Central States plan has been a guarded secret with only the union and four major transportation companies privy to the most up to date information.

What information have you sought in the past that you did not get, or that you did not get in a timely fashion? What additional information do you need? Do you ask for information other than the estimated withdrawal liability?

Mr. WARD. What we would like to receive would be more timely information with regard to the condition of the plan itself, and we do not get that information. Granted, we do not ask, but it has never been available to use. We see it really at the end of 9 months after the end of the particular period in a report through our request for withdrawal liability, just so that we know where that stands at that point.

The CHAIRMAN. I understand that your withdrawal liability increased in recent years from 2–3/10 million to 20 million; is that due entirely to the increased employment of teamster members, or was it the decline of the financial condition of the plan or other withdrawals from the Central States plan?

Mr. WARD. All of the above. We grew our employment from the low 200s number of Teamsters that we employed to 294. We are over 300 today. And calculating withdrawal, they take your contributions over the last 10 years, factor that into the unfunded vested benefit that exists out there, essentially what the liability is, and we have a pro rata share. And with all the carriers that have exited, all the companies that have exited the multi-employer plan, it has just compounded that problem significantly. Add to that, obviously, some of the market conditions prior, but we would suggest that we have been pointing to these issues as far back as MEPA has been in existence, back until 1980.

As Mr. Noddle has suggested, we do not negotiate the benefits. It is very frustrating for us to see a withdrawal liability continue to exist and grow as we grow our business, yet have no say in the setting of those benefits, or for that matter, who sits on the trustee panel.

The CHAIRMAN. Thank you very much. I know we have another panel that we have to get to.

Senator DEWINE. I want to thank all of you very much. We could go on. We appreciate it. It has been very, very helpful. We could go on for a couple hours, I think, but you have all been very helpful. I think it has been an excellent panel, so thank you very much.

Senator MIKULSKI. Mr. Chairman, I concur, and I would welcome the ideas, first of all, additional policy issues raised by the chairman and Mr. Enzi, and I would also like thoughts on governance issues, and help getting some breathing room because the compliance costs must be significant and confusing. Thank you.

Senator DEWINE. We would ask the second panel to come up. They have already been introduced. At this point, I will turn the gavel over to the chairman of the full committee, Chairman Enzi.

The CHAIRMAN. [Presiding] We will go ahead with the next panel then, and appreciate again the participation of everyone.

Mr. Sweetnam?

STATEMENTS OF WILLIAM F. SWEETNAM, JR., ATTORNEY, THE GROOM LAW GROUP, PRESENTING THE TESTIMONY OF JAMES M. DELAPLANE, JR., ON BEHALF OF THE AMERICAN BENEFITS COUNCIL, WASHINGTON, DC; ELLEN COLLIER, DIRECTOR OF BENEFITS, EATON CORPORATION, CLEVELAND, OH, ON BEHALF OF THE COALITION TO PRESERVE THE DEFINED BENEFIT SYSTEM; AND DAVID CERTNER, DIRECTOR, FEDERAL AFFAIRS, AARP, WASHINGTON, DC.

Mr. SWEETNAM. Mr. Chairman, Ranking Member Mikulski, I appreciate the opportunity to appear today, taking the place of James Delaplane.

The CHAIRMAN. Could we ask that as you are leaving that you leave quietly?

Sorry to interrupt.

Mr. SWEETNAM. That is quite all right. I am a partner at the Groom Law Group, and I am appearing here on behalf of the American Benefits Council. The Council is an organization representing Fortune 500 employers and other entities that assist employers in providing benefits to employees. Many of our members sponsor cash balance or other hybrid defined benefit plans.

In our written statement we describe the current legal uncertainty regarding hybrid plans, and provide recommendations to resolve it. But rather than summarize my statement, let me outline a number of significant issues that are pressed upon a chief executive as a result of this legal uncertainty and the negative effects that could well flow from the lack of a clear set of rules.

Under the current pension environment chief executives are finding it difficult to justify a defined benefit plan. These companies voluntarily sponsor a defined benefit plan even though many of their competitors do not. These plans provide valuable benefits to participants and their families and relieve pressure on Government programs. Companies fund their plans through employer contributions. They bear the investment risk and pay premiums to the PBGC to finance insurance guarantees. In fact, over 20 percent of the premiums come as a result of coverage under hybrid plans. Many American companies have restructured their businesses in order to stay competitive in the world marketplace.

The workforce likewise has changed. There are fewer employees who spend their entire career with one employer, more mid-career hires, and there is fierce recruitment competition for talented individuals. In analyzing these developments, many companies have found that a traditional defined benefit plan does not deliver meaningful benefits to this new workforce. Many companies have also found that a majority of the total pension benefits were going to a small share of workers who stayed for a full career. In addition, many companies discovered that they were inappropriately encouraging their employees to retire early and go work for competitors. As part of this analysis, many companies have looked to cash balance and other hybrid plans to meet their needs and the needs of their new workforce. A hybrid plan will deliver benefits more equitably to workers of all tenures, and offer the portability and transparency that employees say that they want.

It is worth noting that the vast majority of participants fare better under a hybrid plan then under a traditional defined benefit

plan. In response to this analysis many companies have realized the benefits a hybrid plan can provide to both employees and to the employer's ability to compete, and as a result, a number of employers have converted their traditional defined benefit plan into a hybrid plan. Many such conversions grandfather a significant group of older workers in the prior plan. Many also make ongoing contributions to employees cash balance accounts that increase with age and service. Many conversions were well received by their employees, and new employees can now see the defined benefit plan as a plus, especially after they receive their annual pension statement.

So is this a positive story about how our voluntary pension system evolves to meet changing employer and employee needs? One would think so, but unfortunately, the story does not end there. Despite significant legal authority to the contrary, a single Federal judge has ruled that the basic cash balance design violates the Pension Age Discrimination statute. Incredibly, he ruled that compound interest in a defined benefit plan is discriminatory. Under this theory each of the 1,200 hybrid plans in this country is illegal. Under this decision a cash balance plan is illegal regardless of whether the cash balance plan is a new plan or whether there was significant grandfathering of old benefits.

So what are the questions that many CEOs are facing in light of this decision? Well, the damages in these age discrimination lawsuits can be enormous, and several other companies already face copycat suits. The fact that a company grandfathered its older workers or increased cash balance contributions as workers age does not matter in these suits. Nor does it matter that employees are happy, since the basic design of the plan and not the conversion has been challenged. It only takes one employee to file suit. So companies that provide a pension benefit that is designed to provide benefits to a wide range of employees find themselves in legal limbo with potentially devastating legal liabilities.

Another concern is on the impact on the company's balance sheet. Given the size of these damage awards, a company's auditors are concerned about this potential liability.

Another factor that raises the concerns of many CEOs is that Congress has prevented the regulatory agencies from addressing the age discrimination issue and is now considering legislation that would, for the first time, grant employees a legal entitlement to future retirement benefits not yet earned.

With these concerns, many CEOs are thinking, why not just have a 401(k) plan like many of my competitors? As an interim step, some companies have decided to freeze their cash balance plan or not let any new employees participate in the plan.

Mr. Chairman and the members of this committee, as policymakers dedicated to the retirement security of American families, I cannot imagine this is the story you want unfolding. Yet this is reality. A recent survey indicates that 41 percent of hybrid plan sponsors will freeze their benefits within a year absent legal certainty.

So it is within your power to change this story. First make it clear that the basic hybrid plan designs do not violate age discrimination rules. Second, provide legal certainty for employers that

have converted to hybrid plans in good faith. And third, reject mandates for future conversions that will discourage employers from making new benefit commitments.

Thank you and I will be happy to answer questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Delaplane follows:]

PREPARED STATEMENT OF JAMES M. DELAPLANE, JR.

Chairman DeWine, Senator Mikulski, thank you very much for the opportunity to appear before you today. My name is James Delaplane, and I am a partner with the law firm of Davis and Harman LLP. I serve as Special Counsel to the American Benefits Council (Council), and I am appearing today on the Council's behalf. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

The Council is very pleased, Mr. Chairman, that you have called this hearing to examine the important policy issues involving hybrid defined benefit plans. Many of our members sponsor cash balance and pension equity plans, and the Council believes that the legal uncertainty currently enveloping these hybrid defined benefit plans is one of the most significant and pressing retirement policy issues presently before Congress. Congressional action to provide legislative clarity and certainty for hybrid plans is urgently needed to prevent (1) the demise of these plans, (2) the resulting exit from the defined benefit system by a large number of American employers, and (3) the harm to the retirement income prospects of millions of American families that will unquestionably result.

Mr. Chairman, we believe it is absolutely critical that the effort to craft hybrid legislation be led by the congressional committees of jurisdiction and we thank you for spearheading this effort. As you are well aware, pension policy is a notoriously complex and technical area, one in which it is easy to produce unintended results, such as disincentives for employers to remain in our voluntary pension system. The legislative process works best when those who are most knowledgeable about an area are the ones to tackle the complex issues. We applaud your commitment to avoid what has sometimes occurred in the past with respect to hybrid plans—haphazard and incomplete debate pursued outside of the committees of jurisdiction and as part of the appropriations process.

In my testimony today, I hope to convey the value of the defined benefit system and hybrid plans specifically for millions of Americans and their families. I will describe the current legal and regulatory landscape that is endangering the continued existence of hybrid plans, and set forth why the Council and its members believe congressional action is urgently needed to prevent the extinction of these retirement programs. Lastly, I will describe the Council's recommendations for resolving this hybrid pension crisis.

THE VALUE OF THE DEFINED BENEFIT SYSTEM

The defined benefit pension system helps millions of Americans achieve retirement security. It does this by providing employer-funded retirement income that is guaranteed to last a lifetime. Employees are not typically required to make any contributions toward their benefits in these plans and the assets of the plan are managed by investment professionals. Employers, rather than employees, bear the investment risk of ensuring that plan assets are sufficient to pay promised benefits. And insurance from the Pension Benefit Guaranty Corporation means employees' retirement benefits are largely guaranteed even if the plan or the employer's business experiences financial trouble.

As of 1999 (the most recent year for which official Department of Labor statistics have been published), nearly 19 million retirees were receiving benefits from defined benefit plans, with over $119 billion in benefits paid out in that year alone.[1] Given that America's personal savings rate remains one of the lowest among industrialized

[1] U.S. CENSUS BUREAU, Statistical Abstract of the United States: 2004–2005, Chart No. 532 (Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin*, winter 2003, and unpublished data).

Nations[2] and that average balances in 401(k) plans are quite modest,[3] there is no doubt that in the absence of defined benefit pensions fewer Americans would be financially prepared for retirement. Furthermore, the absence of defined benefit pensions would result in increased strain on Federal entitlement and income support programs, not to mention an increase in the number of American seniors living in poverty.

Given these statistics, the value of defined benefit plans to many American families is undeniable. Yet we have seen an alarming decline in defined benefit plan sponsorship[4] and today is a particularly precarious time for the defined benefit system. Employers are increasingly exiting the defined benefit system for a variety of reasons, including uncertainty about how future pension liabilities will be measured, a flawed pension funding regime marked by complexity and volatility, the prospect of new and more onerous pension funding and premium requirements, potential changes to the rules governing pension accounting, and, most relevant for our discussion today, legal uncertainty surrounding hybrid defined benefit plans.[5] Objective observers agree that policymakers must take action to address these threats or defined benefit plans and the income they provide to American retirees will become increasingly scarce.[6]

Mr. Chairman, we know that in addition to addressing the hybrid pension issues that are the subject of today's hearing, this subcommittee and the Congress as a whole will be spending considerable time in the months ahead considering potential reforms to the funding rules for defined benefit plans. The Council recently published its recommendations for pension funding reform,[7] and we would welcome the opportunity in a future setting to visit with you and other members of the subcommittee on these important defined benefit plan issues.

THE SPECIFIC ADVANTAGES OF HYBRID DEFINED BENEFIT PLANS

Hybrid plans are defined benefit pensions that also incorporate attractive features of defined contribution plans. The most popular hybrid plans are the "cash balance" design and the "pension equity" design. In a cash balance plan, employers provide annual "pay credits" to an employee's hypothetical account and "interest credits" on the balance in the account. In a pension equity plan, employers provide credits for each year of service and these credits are multiplied by an employee's final pay to produce a lump sum figure. Hybrid plans not only offer the security of employer funding and assumption of investment risk, Federal guarantees and required lifetime and spousal benefit options, but also show account balances in lump sum format, are portable, and provide for a more even benefit accrual pattern across a worker's entire career.[8] Hybrid plan participants are able to reap these rewards typ-

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[2] The Organization for Economic Cooperation and Development, Main Economic Indicators (Paris: OECD, January 2004).

[3] In fact, data from the Employee Benefit Research Institute shows that in 2002 the average 401(k) account balance for workers age 21 to 64 was only $33,647 and the median (mid-point) 401(k) account balance was a mere $14,000. EBRI Notes, Vol. 26 No. 1, (January 2005).

[4] The total number of PBGC-insured defined benefit plans has decreased from a high of more than 114,000 in 1985 to 31,238 in 2004. PBGC Pension Insurance Data Book 2004, 56 & 87. This downward trend becomes even more sobering if you look at just the past several years. Not taking into account pension plan freezes (which are also on the rise but not officially tracked by the Government), the PBGC reported that the number of defined benefit plans it insures has decreased by 8,000 (or 21 percent) in just the last 5 years. *Id.*

[5] The Council last year released a white paper discussing in detail the multiple threats to the defined benefit system, along with recommendations for ensuring that defined benefit pension plans remain a viable retirement plan design. *See* AMERICAN BENEFITS COUNCIL, Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System (May 2004), available at http://www.americanbenefitscouncil.org/documents/definedbenefits_paper.pdf.

[6] "Policymakers should take action sooner rather than later in order to create greater regulatory certainty for plan sponsors. Decisions are needed on the status of cash balance pension plans, permanent funding rules, and interest rates to be used in plan calculations, accounting treatment related to using smoothing versus mark-to-market for investment returns and interest rates, and rules and premiums under Title IV of ERISA and the Pension Benefit Guaranty Corporation. Until these kinds of policy decisions are made, further erosion of the defined benefit system can be expected to continue." Jack VanDerhei and Craig Copeland, EMPLOYEE BENEFIT RESEARCH INSTITUTE, ERISA At 30: The Decline of Private-Sector Defined Benefit Promises and Annuity Payments? What Will It Mean?, Issue Brief No. 269 (May 2004).

[7] AMERICAN BENEFITS COUNCIL, Funding Our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform (February 2005), available at http://www.americanbenefitscouncil.org/documents/fundingpaper021604.pdf.

[8] Traditional defined benefit plans tend to provide the bulk of earned benefits at the very end of a worker's career.

ical of defined contribution plans without bearing any concomitant loss of security (i.e., a decline in account balance due to stock market conditions).

Employers like hybrid plans primarily because the benefits in the plans are so tangible to employees, resulting in greater appreciation of the pension program. In fact, a survey found that the dominant motives for employer conversions to hybrid plans were employee appreciation of the plan, facilitating communication with employees, and the ability to show the benefit amount in a lump sum format.[9] Many assume that conversions are pursued to cut employer pension costs. While this has been the case for some companies, for most employers it is neither the rationale for the conversion nor the reality that results.[10] We trust you will agree that when employers do conclude that costs must be reduced, it is better for them to retain an affordable defined benefit plan (and one that fits the realities of the modern workforce) than to not have one at all.

Hybrid plans and their level benefit accrual pattern are also effective in helping employers attract and retain employees in today's fluid job market where few individuals plan or expect to stay with one employer for a career.[11] Employees likewise appreciate hybrid plans because they are more transparent, more portable, and deliver benefits more equitably to short, medium and longer-service employees than traditional pensions, while also retaining the favorable security features of the defined benefit system.[12]

The unique value of hybrid plans in meeting employee retirement plan preferences is demonstrated in a recent survey. The survey reveals that workers prefer two retirement plan attributes above all others—the portability of benefits and benefit guarantees.[13] It is only hybrid plans that can deliver both these advantages. Traditional defined benefit plans typically do not provide for portability, and benefits in 401(k) and other defined contribution plans are not guaranteed. Indeed, if policymakers were working from a clean slate to produce the ideal retirement plan today, they would likely develop a hybrid plan. Clearly, preserving hybrid plans as a viable pension design is critical if employers are to maintain retirement programs that meet employee needs and preferences.

Perhaps most important of all, studies show that nearly 80 percent of participants build higher retirement benefits under a hybrid plan than a traditional plan of equal cost.[14] Why? Traditional defined benefit plans tend to award disproportionate benefits (often as much as 75 percent of total benefits under the plan) to employees with extremely long service. Yet very few employees spend a career with a single-employer.[15] Hybrid plans were designed to respond to this reality. The advantage of hybrid plans for most workers is confirmed by a recent study that shows that if an employee changes jobs just three times in the course of his career, she or he can expect to receive in excess of 17 percent more in retirement benefits from par-

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[9] Sylvester J. Schieber, et al., WATSON WYATT WORLDWIDE, The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans 44 (February 2000) (96 percent of respondents indicated employees' appreciation of the plan was either very important or important in the decision to convert to a hybrid plan; 93 percent of respondents indicated facilitation of communication and the ability to show the benefit amount in a lump sum format were either very important or important in the decision to convert to a hybrid plan).

[10] Data released shows that retirement plan costs have increased an average of 2.2 percent following a conversion, and when companies that were in severe financial distress were excluded from the pool, this figure increased to 5.9 percent. WATSON WYATT WORLDWIDE, Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce 3 (2004). Conversions are often accompanied by improvements to other benefit programs, such as 401(k) plans, bonuses, and other post-retirement benefits. Another recent survey found that when these improvements are taken into account, 65 percent of respondents expected the costs of providing retirement benefits following a cash balance conversion to increase or remain the same. MELLON FINANCIAL CORPORATION, 2004 Survey of Cash Balance Plans 15. Another survey, conducted in 2000, also found that overall costs following a conversion were expected to increase or remain the same in 67 percent of the cases. PRICEWATERHOUSECOOPERS, Cash Balance Notes 4 (May 2000).

[11] Women rank promoting portable pensions as their top retirement policy priority. CENTER FOR POLICY ALTERNATIVES AND LIFETIME TELEVISION, Survey: Women's Voices 2000.

[12] THE FEDERAL RESERVE, Cash Balance Pension Plan Conversions and the New Economy 5 (Oct. 2003) ("[R]easons that workers may want pensions include the desire to earn tax-favored returns, or to realize economies of scale on the transaction costs of investment, although both of these goals can be realized in a [defined contribution] plan as well as a [defined benefit] plan. In a [defined benefit] plan workers may also realize the opportunity to insure to some degree against mortality, inflation, macroeconomic, and disability risks through inter-and intra-generational risk sharing").

[13] WATSON WYATT WORLDWIDE 2004, *supra* note 10 at 6.

[14] WATSON WYATT WORLDWIDE 2000, *supra* note 9 at 24–25.

[15] WATSON WYATT WORLDWIDE 2004, *supra* note 10 at 6–7. In fact, only 9.5 percent of employees work in the same job for 20 years or more. Employee Benefit Research Institute.

ticipating in cash balance plans than if his or her employers had provided traditional plans instead.[16]

The advantages of the hybrid plan are not reserved for younger workers. Even longer-service workers often fare better under a hybrid plan.[17] One of the many ways in which hybrid plan sponsors address the needs of longer-service and older employees is by contributing pay credits that increase with the age and service of employees. Recent surveys show that 74 percent of cash balance plan sponsors provide pay credits that increase with age or service,[18] while 87 percent of pension equity plan sponsors do the same.[19]

Employers also devote significant energy and resources to developing transition assistance programs to help older and longer-service employees who may not accrue as much in benefits on a going forward basis under a hybrid plan as they would under the prior traditional plan. Successful conversion assistance techniques vary, but generally include one or more of the following: grandfathering some or all current employees in the prior pension plan, allowing certain employees to choose whether to remain in the traditional plan or move to the hybrid plan, providing whichever benefit is greater under either the traditional or new formula, providing additional transition pay credits in an employee's account over some period of time, or making extra one-time contributions to employees' opening account balances. Employers draw from these varying techniques and apply them to smaller or larger groups of employees as appropriate to suit the needs of their workforce and carry out the goals of the conversion. Studies conducted within the last few years show that employers provide older and longer-service employees with these special transition benefits in nearly all conversions.[20] Indeed, employers' already significant focus on the needs of older workers has only increased in light of public and congressional interest in the effect of conversions.

As this data reveals, hybrid plans are proving extremely successful in delivering valuable, appreciated, and guaranteed retirement benefits to employees of all ages.

THE LEGAL AND REGULATORY LANDSCAPE

Let me now turn to a discussion of the history of hybrid plans and how the current uncertainty in the legal and regulatory landscape came about. The first cash balance plan was adopted in 1985 and the first pension equity plan was adopted in 1993. For nearly 15 years after adoption of the first cash balance plan, the Internal Revenue Service (IRS) regularly issued determination letters for hybrid plan conversions indicating that the plans and conversions satisfied all Internal Revenue Code requirements (including those related to age discrimination). In 1999, however, the IRS announced a moratorium on such letters partly in response to several high-profile conversions that were receiving significant congressional and media scrutiny. As a result of this scrutiny and after thorough review of the issues through numerous congressional hearings in the committees of jurisdiction, Congress in 2001 enacted legislation to require employers to provide a more detailed and more understandable advance notice to participants regarding any hybrid conversion (or any other defined benefit plan amendment) that significantly reduced future benefit accruals.[21] At the time, some in Congress proposed various benefit mandates and design restrictions as a response to cash balance conversions, but these proposals were all rejected. Congress concluded that the best response to the issues that had been

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[16] WATSON WYATT WORLDWIDE 2004, *supra* note 10 at 6. The Federal Reserve has likewise reported that "conversions have generally been undertaken in competitive industries that are characterized by tight and highly mobile labor markets. Since mobile workers benefit most from such conversions, we conclude that this trend may have positive implications for the eventual retirement wealth of participants." The Federal Reserve, *supra* note 12 at 3.

[17] WATSON WYATT WORLDWIDE 2000, *supra* note 9 at 23–25 (February 2000) (Among the 78 plans studied, on average a worker age 50 with 20 years of service would have earned benefits 1.48 times as great if he had participated in a cash balance plan rather than a traditional plan).

[18] MELLON FINANCIAL CORPORATION, *supra* note 10 at 12.

[19] WATSON WYATT WORLDWIDE 2004, *supra* note 10 at 2.

[20] MELLON FINANCIAL CORPORATION, *supra* note 10 at 11 (90 percent of conversions contain special transition benefits); WATSON WYATT WORLDWIDE 2004, *supra* note 10 at 4 (89 percent of conversions contain special transition benefits). In those instances where these special transition benefits are not provided, it is usually because the business is in financial distress at the time of the conversion.

[21] ERISA section 204(h); Treas. Reg. § 54.4980F-1 (Notice requirements for certain pension plan amendments significantly reducing the rate of future benefit accrual) (Note: paragraphs (c) and (d) of A-8 of the regulations pertaining to application of the notice requirements to certain amendments reducing early retirement benefits or retirement-type subsidies are proposed and not yet final).

raised was to ensure absolute transparency for employees about how their benefits would be affected by hybrid plan conversions.

Benefit Plateaus ("Wear-Away"). Let me now turn to a discussion of one of the conversion issues that has generated questions and concerns throughout the congressional review of hybrid plans—so called "wear-away." At the outset, it is important to understand that parallel rules in ERISA and the Internal Revenue Code protect all benefits that an employee has already earned for service to date.[22]

Thus, despite assertions to the contrary, existing benefits are never reduced in a hybrid plan conversion.

"Wear-away" is the term used for the benefit plateau effect that some employees can experience in conjunction with a cash balance conversion. When employers convert to a cash balance plan, they typically provide an opening balance in employees' cash balance account. A benefit plateau results if the value of the employee's cash balance account is less than the value of the benefit he or she accrued under the prior plan as of the date of the conversion. Until the value of the cash balance account catches up to the value of the previously accrued benefit, it is the higher accrued benefit to which the worker is entitled if he or she departs the company—hence the plateau.[23] We believe that the term "wear-away" is, in fact, confusing and even misleading, as the employee always receives the higher of the two benefit levels and nothing earned is taken away. Thus, we use the term benefit plateau throughout the discussion below.

There have been three leading causes of this plateau effect in the conversion context.

• First, the plateau can result simply from a change in the rate of interest on 30 year Treasury bonds. Our pension laws require that when benefits earned in a defined benefit plan are converted from an annuity payable at retirement into a lump sum present value, this calculation must be performed using the 30 year Treasury bond rate.[24] As interest rates on 30-year bonds fall, the lump sum present value of the benefit earned by the employee prior to the conversion will increase.[25] The result can be that although a worker's previously earned benefit and opening cash balance account were both equal to $50,000 at the time of conversion, a decrease in 30-year bond interest rates can increase the value of the previously earned benefit to $55,000. Until the cash balance account reaches $55,000, this worker will experience a benefit plateau.

• Second, benefit plateaus can result when employers translate the previously accrued traditional benefit into an opening cash balance account using an interest rate higher than the 30 year bond rate. When this is done, the value of the opening cash balance account will be lower than what the employee would be eligible to take under the prior plan (since the present value of that benefit must be calculated using the 30 year bond rate). The result is that workers will plateau at the higher level until the cash balance account catches up. Employers generally use a higher interest rate when they believe the 30 year Treasury bond rate is historically low (which has been the case in recent years).[26] Yet because using a higher interest rate can produce benefit plateaus and plateaus have been of concern to employees, few employers have set opening balances in this way. The clear trend has been for employers to determine opening account balances using the Treasury rate or a rate

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[22] ERISA section 204(g); Internal Revenue Code section 411(d)(6).

[23] It is worth noting that the use of benefit plateaus as a method of transitioning between benefit formulas has been expressly approved under IRS pension regulations for many years. *See e.g.*, Treas. Reg. § 1.401(a)17-1 (discussing wear-away of benefits in connection with applicable compensation limits), Treas. Reg. § 1.401(a)(4)–13 (regarding correct use of wear-aways in connection with non-discrimination rules), Rev. Proc. 94-13, 1994-1 C.B. 566 (1994) (providing model language including references to wear-aways for use by plans in complying with I.R.C. § 401(a)(17)). Indeed, plateau periods can result from constructive and necessary plan changes, such as updating plan mortality assumptions to provide more accurate benefits, aligning the benefits of employees from different companies in the wake of business acquisitions and mergers, or revising a plan to meet new statutory requirements (such as legislative restrictions on the amount of benefits that may be paid under a plan).

[24] ERISA section 205(g); Internal Revenue Code section 417(e). This required use of the 30-year Treasury bond rate was not changed by the legislation enacted in April 2004 replacing the 30-year rate for pension funding calculations.

[25] This is because one needs a larger pool of money today to grow to an equivalent benefit at age 65 if that pool will be earning less in interest.

[26] This is yet another reminder of how important it is for Congress to move quickly to enact a permanent replacement for the 30 year Treasury bond rate, including for calculations that determine lump sum benefits in defined benefit plans.

more favorable for employees.[27] Thus, this use of higher interest rates has not been a frequent cause of benefit plateaus in recent years.

• Third, benefit plateaus can result when employers eliminate early retirement subsidies (on a prospective basis) from the pension.[28] A plateau can result in this instance because workers who have already earned a portion of an early retirement subsidy prior to a conversion will typically have a previously earned benefit under the prior plan that is higher than the opening cash balance account (which is typically based on the normal retirement age benefit earned under the prior plan as of the date of the conversion and does not include the value of any early retirement subsidy).[29] Presuming an employee leaves the company at a time when he or she is entitled to receive the early retirement subsidy, the prior plan benefit may be greater than the cash balance account. Elimination of the early retirement subsidies on a prospective basis is the primary cause of benefit plateaus in most conversion cases where plateaus are seen today. It should be noted that benefit plateaus can also occur in cases where early retirement subsidies are eliminated from traditional defined benefit plans.

While some may be concerned about the plateau effect resulting from subsidy removal, Mr. Chairman, we feel strongly that employers must maintain their flexibility to eliminate these early retirement subsidies on a going forward basis. Early retirement subsidies are certainly a preferable alternative to layoffs and can help a company manage its workforce in a humane way. But employers will never adopt such features in their plans if policymakers make it difficult or impossible to eliminate these subsidies prospectively when they no longer make sense. Today, for example, given the significant shortages that employers experience in certain job categories, it makes no sense for them to continue to offer highly-productive employees rich financial incentives to retire in their 50s. While current law protects any subsidy that employees have already earned for their service to date, it wisely allows employers to remove such incentives from their plan going forward.

Moreover, any legislative requirement that employers maintain ongoing early retirement subsidies in their pension plans would be out of step with congressional actions regarding our Nation's public pension system, Social Security. Congress has raised the Social Security retirement age—and may once again consider doing so as part of the current effort to address the system's solvency—and repealed the Social Security earnings test, partly in order to encourage older Americans to work longer. Requiring employers to continue to offer private pension plan incentives to retire early would be flatly inconsistent with these actions.

Although we understand that benefit plateaus can be confusing and even upsetting to some employees, they result from interest rate anomalies and valid actions taken by employers to eliminate early retirement subsidies. Nonetheless, given the employee concern, many employers design their conversions to mitigate these plateaus or eliminate them altogether. Moreover, the disclosure requirements enacted by Congress in 2001 (and implemented by the Treasury Department through regulations) ensure that employees are fully aware of the possible benefit plateau effects of a conversion. The Council believes these steps appropriately respond to the concerns that have been raised about plateaus.

Age Discrimination Principles. Subsequent to Congress' enactment of disclosure legislation, the Treasury Department and IRS drafted proposed regulations in consultation with the Equal Employment Opportunity Commission addressing retirement plan design and age discrimination principles. These proposed regulations were issued in December 2002. Among other items, the proposed regulations established the validity of the cash balance design under the pension age discrimination

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[27] In a 2000 study of cash balance conversions, Watson Wyatt reports that of the 24 plans it reviewed that converted to a hybrid design since 1994, 22 of them (92 percent) set opening account balances using the Treasury rate or a rate more beneficial to employees. WATSON WYATT WORLDWIDE 2000, *supra* note 9 at 40; MELLON FINANCIAL CORPORATION, *supra* note 10 at 6 (77 percent of 101 cash balance conversions did the same).

[28] An early retirement subsidy provides an enhanced benefit if the employee leaves the company at a specified time prior to normal retirement age. For example, a fully subsidized early retirement benefit might provide an employee the same pension at age 55, say, $1,500 per month for life, which he would not normally receive until age 65. The ability to earn the higher pension without any actuarial discount for the additional 10 years of payments provides a strong financial incentive to retire at the earlier age. The value of such an early retirement subsidy decreases every year until normal retirement age, at which point no subsidy remains.

[29] Opening account balances do not typically include the value of early retirement subsidies because doing so would provide the value of the subsidy to a large number of workers who will work until normal retirement age and therefore not be entitled to the subsidized early retirement benefits. Those few employers that have included some or all of the subsidy in opening accounts have done so as a particular conversion assistance technique.

statute and provided guidelines on how employers could convert from traditional to hybrid pension designs in an age-appropriate manner.

Disregarding the interpretation contained in the proposed regulations and other legal authorities, one Federal district court judge dramatically shifted the focus of the debate surrounding hybrid plans by declaring in July 2003 in the case of *Cooper* v. *IBM* that hybrid plan designs were inherently age discriminatory.[30] According to the court's flawed logic, simple compound interest is illegal in the context of defined benefit pension plans.[31] Under the *Cooper* court's reasoning, a pension design is discriminatory even if the employer makes equal contributions to the plan on behalf of all its workers and, ironically, even in many instances where the design provides greater contributions for older workers. Such a conclusion flies in the face of common sense.[32] It would hold all 1,200 plus hybrid pension plans,[33] regardless of whether adopted as new plans or through conversion from traditional plans, to be in violation of the pension age discrimination laws.

The conclusion that all hybrid plan designs are inherently age discriminatory begs the question why the Internal Revenue Service issued favorable determination letters for 15 years blessing hybrid plan designs and issued proposed regulations providing that the cash balance plan design is not inherently age discriminatory. It is surprising, at a minimum, that the *Cooper* decision completely ignored this history. Even more astonishing is the fact that the *Cooper* decision ignores the legislative history of the pension age discrimination statute adopted in 1986. That legislative history makes clear that the intent of Congress was limited to prohibiting the practice of ceasing pension accruals once participants attained normal retirement age.[34] Moreover, an example in the 1986 legislative history that clarifies a separate but related pension issue describes approvingly a type of plan (a "flat dollar" plan) that would be deemed age discriminatory under the *Cooper* decision.[35] It makes absolutely no sense that Congress would use as an example of a viable pension design one that would fail the age discrimination prohibition it was enacting at the very same time.[36] Lastly, prior to the *Cooper* decision, numerous other Federal district courts addressed and rejected charges that the basic hybrid plan designs were age discriminatory.[37] These too were ignored in the *Cooper* decision. Importantly, an-

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[30] *Cooper* v. *IBM Pers. Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003). The pension age discrimination statute in question provides that the rate of a participant's benefit accrual may not decline on account of age. The district court interpreted this rule to mean that the amount of annuity benefit received at age 65 for a year of service cannot be less for an older worker than a younger worker. The defendants in the case argued that it is nonsensical from an economic perspective to compare the age 65 benefit accrual rate of a 25 year old and a 64 year old because the 64 year old will receive his or her benefit much sooner and have a much shorter period of time to accrue interest. In other words, the "time value" of money must be taken into account. The court itself acknowledges the strength of this argument, stating, "From an economist's perspective, Defendants have a good argument." Nonetheless, the court goes on to argue that the age discrimination laws require rejection of basic economic common sense.

[31] The court's reading of the 1986 pension age discrimination statute would invalidate a broad range of long-standing pension designs, including contributory defined benefit plans (common in the State and local Government sector and among multi-employer plans), plans that are integrated with Social Security and plans with pre-retirement indexation to help protect employees from the effect of inflation. These plans were all regarded as perfectly age appropriate when Congress enacted the pension age statute.

[32] If the *Cooper* court's reasoning were applied to the Social Security program, even it would be considered age discriminatory.

[33] The most recent Government data indicates that as of the year 2000 there were 1,231 hybrid plans covering more than 7 million participants. PBGC, *supra* note 4 at 3–6.

[34] H.R. CONF. REP. NO. 1012, 99th Cong., 2d Sess. at 376–379. A number of other Federal district courts that have had the opportunity to review this issue have likewise concluded that the pension age discrimination statute is only applicable to benefit accruals after a participant has reached normal retirement age. *See Tootle* v. *ARINC, Inc.*, 222 F.R.D. 88, 92–94 (D. Md. 2004); *Engers* v. *AT & T Corp.*, No. 98–3660, letter op. at 9 (D. N.J. June 6, 2001); *Eaton* v. *Onan*, 117 F. Supp. 2d 812, 827-29 (S.D. Ind. 2000).

[35] H.R. CONF. REP. NO. 1012, 99th Cong., 2d Sess. at 381.

[36] *Eaton* acknowledged this inconsistency and concluded it was illogical to read the pension age discrimination statute in such a way as to invalidate this example and with it a wide variety of defined benefit plans. 117 F. Supp. 2d at 830, 834.

[37] *Campbell* v. *BankBoston*, N.A., 206 F. Supp. 2d 70 (D. Mass. 2002) (rejecting the notion that hybrid plan designs are inherently age discriminatory, the court stated that a "claim based on the fact that older workers will have a smaller amount of time for interest to accrue on their retirement accounts . . . is not permitted under the [age discrimination laws]."), *aff'd* 327 F.3d 1 (1st Cir. 2003); *Eaton* v. *Onan*, 117 F. Supp. 2d 812, 826 (S.D. Ind. 2000) (in holding that the cash balance pension design is not age discriminatory the court stated: "Plaintiffs' proposed interpretation would produce strange results totally at odds with the intended goal of the OBRA 1986 pension age discrimination provisions").

other Federal district court decision decided subsequent to *Cooper* has rejected its logic and concluded that the cash balance pension design is age appropriate.[38]

Spurred on by the *Cooper* decision, cash balance critics in Congress pushed through an appropriations prohibition preventing the Treasury Department from finalizing its age regulations addressing hybrid plan designs and conversions.[39] Congress at the same time directed the Treasury Department to make legislative recommendations regarding conversions from traditional to cash balance plans.[40] In the relevant legislative history, however, Congress did make clear that "[t]he purpose of this prohibition is not to call into question the validity of hybrid plan designs (cash balance and pension equity). The purpose of the prohibition is to preserve the status quo with respect to conversions through the entirety of fiscal year 2004 while the applicable committees of jurisdiction review the Treasury Department's legislative proposals."[41]

While the *Cooper* decision is an isolated one, and there is clear and significant authority to the contrary concluding that hybrid plans are age appropriate, *Cooper* is a high-profile case that has led to copycat class action lawsuits being filed against a number of other employers for the alleged discriminatory nature of their plan design. Applying the rationale in the *Cooper* rulings, ultimate damages against the defendant were projected to be between $1 and $6 billion dollars. It is this range of figures that are required to overcome and "correct for" the natural operation of compound interest. Indeed, should the defendant in the Cooper case lose its planned appeal on the cash balance plan and related design issues, it has agreed to settle these two particular claims for $1.4 billion. Employers are understandably extremely anxious about the crippling effect of such lawsuits and potential damage awards, and are concerned that they will be next on the growing list of companies targeted for class-action suits. While employers certainly expect the anomalous *Cooper* decision ultimately to be overturned on appeal, such a result is many months, if not years, away and many hybrid plan sponsors are likely to find the intervening risks to their businesses and shareholders to be unbearable.

THE NEED FOR CONGRESSIONAL ACTION

Mr. Chairman, the operation of the hybrid pension system is at a standstill. Employers cannot get determination letters from the IRS regarding the compliance of their plans with legal guidelines. The regulatory agencies that normally assist the smooth functioning of the system through issuance of periodic interpretive guidance have been told by Congress through the appropriations process not to do so. Any final resolution of the age discrimination question by the Federal appellate courts is years away at a minimum.

Moreover, the judicial system is not the appropriate forum for resolving an issue of this sort, which has far-reaching public policy ramifications. The very nature of the judicial process makes it difficult for these types of broad public policy issues to receive thorough examination much less appropriate handling. Not all stakeholders are present before the court and the system-wide ramifications are intentionally given less weight than the narrow legal issues.

Perhaps some are tempted to view this current legal uncertainty and regulatory standstill as a victory of sorts. Perhaps they will see the slowdown in the number of hybrid plan conversions as a positive development for employees. They should not. As we noted earlier, other pressures in the defined benefit system are already prompting employers to consider freezes or terminations of their plans. Indeed, a recent survey reported that 27 percent of defined benefit plan sponsors have already frozen at least some element of their defined benefit pension program.[42] The hostile climate for hybrid plans and the litigation risks and extreme damage potential are unfortunately starting to make the decision to freeze an easier and easier one for corporate decision-makers.[43] If employers are pushed to abandon hybrid plans, we

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[38] *Tootle* v. *ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004).

[39] See Section 205 of the fiscal year 2004 Omnibus Appropriations Act (PL 108–199).

[40] These Treasury Department recommendations were included in the Bush Administration's fiscal year 2005 and fiscal year 2006 budget submissions to Congress.

[41] H.R. CONF. REP. NO 401, 108th Cong., 1st Sess. at 1185 (2003).

[42] Society of Actuaries' Survey on the Prevalence of Traditional and Hybrid Defined Benefit Plans, prepared by Matthew Greenwald and Associates, Inc. (March 2005).

[43] A majority of companies have made it clear that if hybrid plans become untenable they will be offering only a 401(k)/defined contribution program going forward. They will not be reverting to a traditional defined benefit plan design. DELOITTE CONSULTING LLP, Pension Crisis Prompting Majority of Surveyed Companies to Change or Consider Changing Their Plans 2 (2004). While defined contribution plans provide valuable retirement benefits, defined benefit plans provide unique retirement security features for employees and their families that are hard to replicate. Employees are typically best served by the ability to participate in both types of plans.

will lose a retirement vehicle that delivers higher benefits to the vast majority of employees and meets workers' key retirement plan needs—for portability and benefit guarantees—all while utilizing transition methods that protect older workers. How, exactly, is this good for employees and their families?

The prospect of hybrid plan freezes and terminations poses another risk—to the Pension Benefit Guaranty Corporation (PBGC). We must be mindful that many of the companies that sponsor hybrid plans are financially strong companies in healthy industries. These strong companies today pay insurance premiums to the PBGC. If these employers are forced to exit the defined benefit system, the loss of premiums could aggravate the long-term financial challenges faced by the agency. Hybrid plan participants comprise 21 percent of all plan participants protected by the PBGC insurance program. Hence employer insurance premiums on these participants comprise 21 percent of the revenue generated by the PBGC through its per-participant premium program.[44] If hybrid plans were removed from the defined benefit system, future premiums to the PBGC would be reduced significantly.

Mr. Chairman, the situation today is distressingly clear. The harms that result from today's legal uncertainty are unmistakable. The regulatory agencies and courts are unable to act effectively to prevent these harms. Only through prompt legislative action can Congress rescue hybrid defined benefit plans and prevent the damage to the retirement security of millions of American families that will unquestionably result from their demise.

RECOMMENDATIONS

Clarify the Age Appropriateness of the Hybrid Plan Designs. The first and most important step for Congress to take is to clarify that the cash balance and pension equity designs satisfy current age discrimination rules. Congress must make clear that the legal interpretation holding these designs discriminatory merely because the accounts of younger workers have more years to earn interest is unfounded. Rather, Congress must clarify that age discrimination in defined benefit plans is measured by reference to the formula spelled out in the plan document. If, under the formula, benefits do not decline on account of age, then the plan meets the legal requirements. In hybrid plans, this approach would look to the pay credits contributed on workers' behalf under the plan formula. If the pay credits for older workers are the same, or greater, than the pay credits for younger workers, then the pension age discrimination rules are satisfied.[45] This clarification is consistent with the legal authorities and with plain common sense. It will end the needless legal jeopardy in which every hybrid plan sponsor today finds itself and will preserve the important benefits that millions of employees today earn under these plans.

Provide Legal Certainty for Past Hybrid Conversions. In addition to clarifying the age appropriateness of the hybrid plan designs, the Council believes it is essential for Congress 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. Transition methods, such as benefit plateaus, that have not given rise to concerns about age discrimination in other contexts should not now do so merely because of the context of hybrid plan conversions.

Resolve Legal Uncertainties with Anti-Employee Effects. Beyond resolving the questions about the basic hybrid designs and the treatment of past conversions, the Council believes Congress should take a number of additional steps to provide legal clarity regarding hybrid plans. Addressing these additional issues will very concretely aid the employees who participate in hybrid plans.

• **Whipsaw.** First, we recommend that you make clear that, so long as a cash balance plan does not credit interest in excess of a market rate of return, the proper benefit payment to a departing employee is that employee's account balance. This

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The Council believes that our Nation's retirement income policy should be crafted to promote maximum flexibility so that employers and employees can utilize the plan or plans that best suit their needs.

[44] This figure is derived from data collected by the PBGC indicating that, as of the year 2000, the PBGC protected 34,342,000 single-employer defined benefit plan participants, 7,155,000 of whom participate in hybrid plans. PBGC, *supra* note 4 at 6.

[45] The hybrid plan proposals made by the Treasury Department in the Bush Administration's fiscal year 2005 budget contain a provision recognizing that this is the appropriate way to evaluate age discrimination for hybrid plans. However, this clarification regarding the hybrid plan designs is prospective only in the Treasury recommendations, leaving employers with hybrid plans already in existence open to legal suit regarding the legality of their plan designs.

will remedy the so-called "whipsaw" problem that has forced employers to reduce the rate of interest they pay on employees' cash balance accounts.[46]

The Treasury Department helpfully included this same resolution of the whipsaw problem in its legislative recommendations contained in the Bush Administration's fiscal year 2005 budget proposal. As with the provision regarding hybrid plan design, however, the recommended whipsaw fix was prospective only. This would require employers to continue to pay low interest rates on employees' existing cash balance accounts.

• **Inclusion of Early Retirement Subsidies.** Second, we recommend that you make clear that employers may include some or all of the value of early retirement subsidies in employees' opening account balances. A number of employers have chosen to do this as a conversion technique to assist those nearing early retirement eligibility, but some in the regulatory agencies are suggesting that to do so is problematic under our current pension age discrimination rules.

• **Protection of "Greater Of" Transition Method.** Third, we recommend that you make clear that employers that voluntarily choose to offer employees the greater of the benefits in the prior traditional or new hybrid plan do not run afoul of the pension back-loading rules. Some regulators have suggested this "greater of" conversion approach violates these rules.

• **Protection of Employee-Friendly Transition Techniques.** Fourth, some conversion approaches that employees and Members of Congress have praised (choice, greater of, grandfathering in the prior plan) are likely to violate the non-discrimination rules over time. Why? The group of typically older employees who remain under the prior plan formula will over time and very naturally have a greater and greater proportion of so-called highly-compensated employees (those making $95,000 and above) and may well be the only group eligible for continued accrual of benefit features exclusive to the prior traditional plan (e.g., early retirement subsidies). This creates a problem under the non-discrimination rules. We urge you to make clear that these employee-friendly conversion techniques can be pursued.

Reject Benefit Mandates That Prevent Employers from Modifying Benefit Programs. Some in Congress are seeking to impose specific benefit mandates when employers convert to hybrid pension plans. For example, some have proposed requiring employers to pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others have proposed requiring 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. Pursuant to a directive from Congress, the Treasury Department has also made legislative recommendations regarding requirements for hybrid plan conversions undertaken in the future. Despite earlier proposed regulations that would have clarified the legality of the hybrid plan designs and made clear that conversions could be undertaken without special benefit requirements, the Treasury's legislative proposal would require employers to pay benefits at least as high as were provided under the prior traditional plan for a period of 5 years following the conversion.

These proposals may perhaps sound innocuous to some, and indeed some employers have voluntarily adopted the transition techniques that would be mandated under these proposals, but each of the proposals embraces a fundamental and truly radical shift in the rules of the game for our Nation's voluntary employer-sponsored benefits system. Under these proposals, Congress would be (1) guaranteeing employees future retirement plan benefits for service that the employees have not yet performed, and (2) preventing employers from changing the benefit programs they voluntarily offer. Indeed, Congress would be converting the natural and understandable hopes and wishes of employees that their benefits will remain the same into concrete legal rights. Such enshrinement of expectations is a fundamental departure from the existing rules of the voluntary benefits system. The Council believes this

[46] Whipsaw is the term used to describe the anomaly that occurs when employers must project a departing employee's cash balance account forward to normal retirement age using the plan's interest crediting rate and then must discount the resulting amount back to a present value using the statutorily-mandated 30 year Treasury bond rate. When an employer's interest crediting rate is higher than the 30 year rate, this process results in a plan liability to the employee in an amount greater than the employee's actual account balance. The only way to avoid this "whipsaw" effect is to reduce a plan's interest crediting rate to the same 30 year rate the law requires for discounting future benefits into present value lump sums. In the wake of several court decisions mandating this whipsaw effect, this is what cash balance sponsors around the country have done to insulate themselves from liability. However, the unfortunate result is that employees in cash balance plans earn lower rates of interest on their accounts than would otherwise be the case. Even a modestly lower rate of interest earned on an account over the course of a career can translate into a significant reduction in the ultimate account balance at retirement.

would be an extremely unwise—and extremely counterproductive—step for Congress to take.

Under such regimes, it is unfortunately clear what actions employers will take in our voluntary benefits system. If they conclude that a traditional defined benefit plan is no longer meeting business and employee needs, they will not remain in the defined benefit system through conversion to a hybrid plan. They will exit the defined benefit system altogether knowing they can avoid these unprecedented mandates by simply utilizing a defined contribution plan going forward. As discussed above, this is typically not the response that best serves employees' retirement income needs.

Perhaps even more damaging than pushing employers from the defined benefit system is the dangerous precedent that would be set by these mandates that seek to enshrine expectations. Employers will naturally ask themselves whether, if other developments in the benefits and compensation landscape come in for heightened scrutiny, Congress will respond by preventing them from making changes to those programs (through imposition of greater of, mandated choice or hold-harmless requirements). Will employers be unable to redesign their health plans? Will they be unable to remove early retirement subsidies from their traditional defined benefit plans? Will they be unable to reduce cash bonuses? Will they be unable to shift from profit-sharing to matching contributions in their defined contribution plans? Will they be unable to reduce the degree of price discount in their stock purchase programs? Where exactly will it end? There appears to us to be no principled stopping point.

Given the extremely significant administrative burdens, financial costs and legal exposure that already accompany voluntary employer sponsorship of benefit programs today, we hope all who believe in employer-provided benefits as we do will see that these are not the questions you want stirring in the minds of corporate decision-makers. They can only result in a world where employees are offered fewer benefits.

CONCLUSION

The American Benefits Council believes that hybrid defined benefit plans play an invaluable role in delivering retirement income security to millions of Americans and their families. Nevertheless, hybrid plans are facing legal uncertainties that threaten their continued existence. Of these, the most pressing threat is a rogue judicial interpretation that declares all hybrid plans in the Nation illegal. To prevent widespread abandonment of hybrid plans by employers and the resulting harm to employees, we hope Congress will provide the legislative certainty and clarity for hybrid pension plans we have recommended above.

Thank you again, Mr. Chairman and Senator Mikulski, for the opportunity to appear today. I would be pleased to answer any questions you may have.

The CHAIRMAN. Ms. Collier?

Ms. COLLIER. Chairman Enzi, Senator Mikulski, thank you for the opportunity to appear today. My name is Ellen Collier, and I am the Director of Benefits for Eaton Corporation. Eaton is a diversified industrial manufacturer with world headquarters in Cleveland, OH. We have over 56,000 employees worldwide, including 29,000 employees in more than 40 States. Our business has changed considerably over the past 10 years, a result of more than 100 acquisitions and divestitures.

I am appearing today on behalf of the Coalition to Preserve the Defined Benefit System, a broad-based employer coalition that works exclusively on legislative and regulatory issues related to hybrid plans. This is a critical time for defined benefit pension plans, and hybrid plans in particular. Congressional action is urgently needed to confirm the validity of cash balance and pension equity designs. If Congress does not act to clarify the current legal uncertainty, employers, facing the threat of class action lawsuits, will increasingly be forced to abandon these retirement programs.

Given the success of hybrid plans in delivering meaningful guaranteed retirement benefits to today's workers, abandonment of these programs would be disastrous for our employees and for our

Nation's retirement system. Employees will lose if the current uncertainty persists.

Let me now discuss why we at Eaton concluded that a cash balance plan was right for us. Eaton's diverse business nature and acquisition activity created a challenge for our retirement programs to continually attract and retain high-level talent and to reduce the confusion resulting from multiple pension structures. We began to examine different pension alternatives in the mid 1990s. While this was under way we acquired Aeroquip Vickers, a company with about 5,000 nonrepresented employees. These employees had no defined benefit pension plan, making the development of a new pension program even more urgent.

We considered several options for a new pension design, but in the end we decided that a cash balance plan was best for Eaton and our employees. Why? The simplicity, visibility, portability and ease at integrating acquired companies into Eaton. Once we settled on an ongoing design we had to make sure we responded to the needs of employees who were already in other pension designs. All new hires would start in the cash balance program, 1/1/02, as would the Aeroquip Vickers employees. 15,000 nonrepresented employees would receive an informed choice, effective 1/1/03, between remaining in their traditional defined benefit plan and switching to the cash balance plan.

Employee reaction to our cash balance design was overwhelmingly positive. It is important to note that choice may not make sense for all companies. Employers need to have flexibility to modify retirement plans to meet their individual business needs. Let me emphasize Eaton did not introduce a cash balance plan to reduce costs. In fact, the new cash balance design has increased our costs.

Although the choice process required a significant amount of time and resources and money, the cost of congressional inaction would be far greater. If certain proposed judicial remedies were applied to Eaton, the cost to modify our plan could curtail discretionary spending in vital areas like research and development. Furthermore, there would be increased litigation, confusion and complexity if we were forced to modify or freeze our plans at this time.

The resulting damage to employee morale and trust would greatly disrupt Eaton's day to day manufacturing operations. Without legislative action, our efforts to align our benefit structure with our business needs will have been wasted.

Mr. Chairman, legislation is the only effective way to address today's uncertainty surrounding the hybrid pension designs. Why? Congress has indicated through the appropriations process that it does not want these important policy issues being determined by the agencies, and final resolution of the age discrimination issue by appellate courts is years away at a minimum. This will be too late to address the litigation risks that are already beginning to drive employers from the system. In the meantime, retirement security of millions of American families will remain in limbo. To provide widespread abandonment of pension plans by employers, Congress must clarify the legality of hybrid plans.

Thank you again for the opportunity to appear here. I would be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Collier follows:]

PREPARED STATEMENT OF ELLEN COLLIER

Chairman DeWine, Senator Mikulski, thank you for the opportunity to appear today. My name is Ellen Collier and I am the Director of Benefits at Eaton Corporation. Eaton Corporation is a diversified industrial manufacturer headquartered in Cleveland, Ohio. We have over 56,000 employees worldwide, including over 29,000 employees in 100 locations in the U.S. The States with our greatest concentration of employees are North Carolina, Michigan, Ohio, South Carolina, Iowa and Pennsylvania. In total, we have employees in over 40 States.

Eaton has four main business groups that manufacture highly-engineered components: Fluid Power, which manufactures hydraulic components, hoses and connectors, and Aerospace products; Electrical, which manufactures residential and commercial power distribution equipment; Automotive, which manufactures engine valves, lifters and superchargers; and Truck, which manufactures transmissions for heavy and medium duty trucks.

Our 2004 sales were nearly $10 billion, and we sold products in more than 125 countries. The business mix of the company has evolved significantly in the past 10 years as a result of more than 100 acquisitions and divestitures. About 65 percent of Eaton's revenues come from businesses that we acquired in the past 7 to 10 years.

I am appearing today on behalf of the Coalition to Preserve the Defined Benefit System, a broad-based employer coalition that works exclusively on legislative and regulatory issues related to hybrid pension plans. The Coalition's more than 75 member companies, which range from modest-size organizations to some of the largest corporations in the U.S., sponsor hybrid defined benefit plans covering more than 1.5 million participants.

THE NEED FOR LEGISLATIVE ACTION

I want to thank you for calling this hearing to address what is one of the most pressing challenges today in the defined benefit system—the legal uncertainty surrounding hybrid plans, and in particular the radical judgment by a single court that hybrid plans are age discriminatory. Congressional action is urgently needed to confirm the dominant view—expressed by all other legal authorities—that the cash balance and pension equity designs satisfy current age discrimination rules. Absent such action by Congress to clarify the current legal environment, employers facing the threat of copycat class action lawsuits over the validity of their plan designs will increasingly be forced to abandon these important retirement programs. Given the success of hybrid plans in delivering meaningful, guaranteed retirement benefits to today's workers,[1] abandonment of these programs would be a disastrous result for employees and for our Nation's retirement system. Moreover, with the long-term solvency challenges facing the Social Security program, it is more important than ever to encourage employers to offer robust workplace retirement programs—or certainly not discourage them from doing so. None of us should kid ourselves that somehow employees win if the current uncertainty persists. Nor should any of us assume that a retreat from hybrid plans will be accompanied by a return to traditional defined benefit plans. Indeed, it is far more likely that employers will abandon defined benefit plans altogether.

Congress has before it a number of pressing issues involving our Nation's defined benefit pension system, including the need to enact a permanent interest rate to govern the measurement of pension liabilities and required contributions. These are important issues to Eaton and Coalition members generally but we sincerely hope that congressional attention to pension reform funding issues will not distract from the critical task of acting this year to address the hybrid plan issues.

To give you a feel for the valuable role hybrid plans play, let me now discuss why we at Eaton concluded that a cash balance plan was right for us. Our experience is comparable to those of many other companies in our Coalition.

[1] Nearly 80 percent of employees earn higher benefits under a hybrid plan than under a traditional defined benefit plan of equal cost. WATSON WYATT WORLDWIDE, The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans 24–25 (February 2000). As discussed below, those employees who do better under a traditional defined benefit plan are typically granted transition assistance and/or remain under the traditional formula after the hybrid plan is introduced.

THE NEED FOR A NEW PENSION DESIGN

Eaton's presence in various lines of business, and our substantial acquisition activity, created a challenge for our retirement programs: we needed to continue to attract and retain high-level talent to remain competitive and continue our growth, and we also needed to reduce the confusion and administrative cost resulting from multiple pension structures inherited through various acquisitions. Through different acquisitions and across different lines of business we had six ongoing pension designs for 15,000 non-union represented employees. These included two final average pay designs, one Social Security offset design, two flat-dollar multi-employer designs, and one cash balance design. Based on employee survey results, we also knew we needed to make our pension plans easier for employees to understand.[2]

Eaton began to examine pension plan alternatives in the mid-1990's. We knew the resulting design would need to be attractive to high-skills talent, easy to understand, and suitable to a mobile workforce. This attention to mobility was important—not only because of general trends in the labor marketplace, but also because within Eaton we have employees that transfer between business groups with different pension plans. Under our existing traditional designs, one employee could have benefits from two pension plans, simply by transferring from Pittsburgh (headquarters of our Electrical group) to Minneapolis (headquarters of our Fluid Power group). Finally, any new retirement program would have to permit seamless integration of new employees brought on as a result of acquisitions. This was necessary in order to provide equitable and uniform benefits across our workforce and to enhance Eaton's ability to grow.

While the examination of pension plan alternatives was underway, Eaton acquired Aeroquip Vickers, a company with about 5,000 non-union represented employees. These employees had a defined contribution plan from the prior owner, but no ongoing defined benefit plan—their pension plan had been frozen many years before. We at Eaton felt strongly that we wanted to provide these employees once again with the security of a defined benefit plan—in addition to Eaton's 401(k) plan (which has an employer match). We knew that employer funding and assumption of investment risk, professional investment management and Federal insurance guarantees translated into tangible retirement income and significant peace of mind for employees. Thus, the need to integrate the Aeroquip Vickers employees into Eaton's benefit structure and our desire to offer them a defined benefit pension made the development of a new pension design even more urgent.[3]

KEY CONSIDERATIONS

We considered several options for a new pension design, including a final average pay plan, a cash balance plan, and a pension equity plan (the other primary variety of hybrid pension plan). We also considered a defined contribution-only program (which we did not prefer, since it lacked the security of a defined benefit plan). In the end, the simplicity, visibility, portability, and ease with which an acquired company could be integrated led us to choose a cash balance design.[4] Along the way, we kept abreast of all regulatory and judicial developments to ensure we were designing a plan that would meet the relevant legal standards. Like most other companies that consider switching to a hybrid plan, Eaton engaged the full range of outside consultants and experts to do appropriate due diligence and assist us with the conversion process.

Now that the basic hybrid designs have been called into question, employers facing a set of circumstances similar to ours would have far fewer options. One choice would be to stay with the traditional pension design, which tends to deliver meaningful benefits to a relatively small number of career-long workers, has limited value as a recruitment device in today's marketplace and makes integration of new employees difficult. The other alternative would be to exit the defined benefit system and provide only a defined contribution plan, which while an important and popular benefit offering, provides none of the security guarantees inherent in de-

[2] This correlates with the general experience of other employers. Surveys show that the most important factors underlying employer conversions to hybrid plans are improving communication about and employee appreciation of the pension plan, as well as being able to show benefits in a lump sum format. WATSON WYATT WORLDWIDE 2000, supra note 1 at 44.

[3] Eaton's growth through acquisition is a trend that has continued. Just last year, we acquired Powerware, a company with over 1,100 U.S. employees and a frozen pension plan. Because of this acquisition, all former Powerware employees regained pension coverage by participating in the Eaton Personal Pension Account.

[4] Once again, Eaton's reasons are consistent with those of other employers that move to hybrid plans. WATSON WYATT WORLDWIDE 2000, supra note 1 at 44.

fined benefit plans. As these alternatives make clear, it is employees that lose out as a result of today's uncertainty surrounding hybrid plans.

As we at Eaton analyzed our specific situation, we took into account the needs of employees that were already in our other pension designs. We knew that a cash balance design might not meet the needs of every current employee in our existing traditional plans. However, we also knew that forcing current workers to remain in their existing traditional defined benefit plan, while working side-by-side with new workers who earned what might be perceived as a more valuable benefit under the new cash balance design, was also not desirable.

Once we settled on cash balance as our new ongoing design, we then focused on the particular transition approach we would adopt. We were aware of the diversity of transition approaches and knew that each of these transition techniques had proven successful at addressing the needs of particular companies' older workers. Such approaches include grandfathering employees in the prior traditional plan, offering employees the choice between the prior traditional and new hybrid formulas, providing the "greater of" the benefits under the prior or hybrid plan, providing transition pay credits or making one-time additions to employees' opening cash balance accounts.

These special transition techniques are used in the vast majority of conversions, and the variety of approaches provides the flexibility companies need to address their unique circumstances and employee demographics.[5] Indeed, congressional concerns about how older and longer-service workers are treated during conversions have been successfully addressed by employers through the use of the variety of transition protections.[6]

We decided that all 15,000 current non-union employees—regardless of age or service—would be able to choose whether to remain in their existing traditional plan or earn a pension benefit under the cash balance formula. This choice would be effective 01/01/03. In addition, all of the recently acquired non-union Aeroquip Vickers employees would enter the new cash balance plan on 01/01/02, and all non-union Eaton employees hired on or after 01/01/02 would enter the new cash balance plan.

We should emphasize that Eaton did not introduce a cash balance plan to reduce cost, and in fact the new plan increased costs in the short-term, and will slightly increase plan costs in the long-term. This is described in more detail below.

DESCRIPTION OF PLAN DESIGN

Our new cash balance design—the Eaton Personal Pension Account, or EPPA—consists of several important features. Each participant earns monthly pay credits based on the sum of their age and years of service (including any service with an acquired company). These credits range from 5 percent of pay up to 8 percent, increasing as the sum of age and years of service increases. To reiterate, we contribute higher pay credits to the cash balance account of older employees and those with longer service. Indeed, providing pay credits that increase with age or service is the typical approach in hybrid plans.[7] Under Eaton's plan, the pay credits accumulate,

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[5] MELLON FINANCIAL CORPORATION, 2004 Survey of Cash Balance Plans 11 (90 percent of employers provide special transition benefits); WATSON WYATT WORLDWIDE, Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce 4 (2004) (89 percent of employers provide special transition benefits). Those employers that do not (and that simply convert the prior accrued benefit into an opening account balance without additional transition techniques) are typically experiencing financial distress at the time of the conversions. Yet despite their financial challenges, they are interested in retaining a defined benefit plan that delivers meaningful benefits across their workforce.

[6] This discussion of conversions highlights another reason why legislative action is so urgently needed. Many employers that have converted to hybrid plans using these successful and generous conversion methods have nonetheless been unable to obtain a determination letter from the Internal Revenue Service (IRS) stating that their plan complies with the requirements of the Internal Revenue Code. This is due to the fact that the IRS announced a moratorium on issuance of such letters for hybrid conversions in September 1999 pending review of some of the hybrid issues by the IRS national office. Memorandum from the Internal Revenue Service to the EP/EO Division Chiefs (Sept. 15, 1999). It has become clear that the IRS will not begin issuing determination letters (for either past conversions caught up in the moratorium or new conversions) until Congress resolves the legal uncertainty surrounding hybrid plans. The absence of determination letters harms both employers and employees. The determination letter process works as a partnership between employers and the Government to ensure that plans are maintained in accordance with our Nation's very complex pension statutes and regulations. The fact that this process has broken down means that employers are not getting the definitive guidance they rely upon to operate their plans in full compliance with the law.

[7] Seventy-four percent of 146 employer respondents to a Mellon survey provided pay credits in their cash balance plans that increased with age or service. MELLON FINANCIAL CORPORA-

Continued

with interest based on the rate of interest for 30 year Treasury bonds, to create the "personal pension account." Our design benefits employees of a company acquired by Eaton since it recognizes past service with that company when calculating the level of pay credits. The cash balance design is also helpful in recruiting mid career talent, since age (and not just service) is a component in the calculation of pay credits. Note that we received an IRS determination letter for this basic cash balance design in November of 2002 as it applied to the new Eaton hires and the Aeroquip Vickers employees (none of whom experienced a conversion).[8] We have also received determination letters for our other active cash balance plan and another cash balance plan that has since been frozen due to a spin-off.

An employee who chose to switch to the new Eaton Personal Pension Account would start with an opening account balance equal to the value of their pension benefit under the existing traditional pension plan—including any early retirement subsidies or supplements.[9] Since one of our goals with the new design was to make our pension plan easier for employees to understand, we felt that using an opening balance approach, as opposed to using the existing traditional formula for past benefits and a cash balance formula for future benefits (the so-called "A+B" approach), was appropriate. To calculate these opening balances, we assumed a retirement date of the later of age 62 or 01/01/06. Employees whose prior pension formula was tied to their final pay (this included the vast majority of the employees eligible for making an informed pension choice) also received indexing credits on the opening balance amount for as long as they remained active employees. These indexing credits were based on annual changes in the Consumer Price Index (CPI) to mimic the effect that pay increases would have had on the employees' prior pension benefit. These indexing credits were in addition to the ongoing interest and pay credits mentioned above. So, each month a participant's balance would increase by pay credits, interest credits on the prior balance (including any past pay credits), and indexing credits (on the opening balance only).

Employers have taken a variety of approaches to the question of whether to include early retirement subsidies in employees' opening account balances. Some have chosen not to do so since it is impossible to know at the time of conversion whether employees will actually leave the company at a time in the future when they would have qualified for the subsidy. Others, like Eaton, have included some or all of the value of the subsidy in the opening cash balance account as one technique to minimize the effect of the conversion for employees nearing early retirement eligibility.

It is important to note that current law protects any subsidy that an employee may have already earned at the time of a conversion. To qualify for this subsidy, the employee must of course retire at the retirement eligibility age. Of equal importance, current law also allows employers to remove such incentives from their plans on a going forward basis.

A final, but important, note regarding our plan design change is that we made several costly changes to the existing traditional plans as well. Our intention was to remove certain differences in the plan designs in order to make the choice process even more equitable. For instance, we added a non-spousal death benefit and an enhanced disability pension provision to the traditional plans—both were features of the new cash balance design—to ensure that an employee's choice would not be skewed by concerns over unexpected death or disability. We had concluded that the existing "spouse-only" death benefit in our traditional plans was not meeting the needs of single parents working at Eaton.

Along with changes in our pension plan, we also made important changes in our 401(k) savings plan. These changes included permitting diversification of the company stock matching contribution. The decision to permit diversification had been made prior to news reports of troubled company savings plans, such as Enron.

TION, supra note 5 at 9. Eighty-seven percent of pension equity plans analyzed in a recent Watson Wyatt study provided pay credits that increased with age or service. WATSON WYATT WORLDWIDE 2004, supra note 5 at 2.

[8] Due to the IRS moratorium on determination letters discussed above, we do not have a determination letter for our core cash balance conversion affecting Eaton employees as of 12/31/02.

[9] An early retirement subsidy in a pension plan provides a financial bonus for employees to retire early. To provide a simple example of a fully subsidized benefit, a worker retiring at age 55 might receive the full $1,000 per month pension benefit he would normally only be entitled to at age 65. In other words, there is no actuarial reduction in benefits for the early retirement date. One thousand dollars per month for life beginning at age 55 is more valuable than $1,000 per month for life beginning at age 65; hence the subsidy. The subsidy declines in value if the employee remains at the company beyond age 55 and has no remaining value if the employee works until 65. In contrast, early retirement supplements are additional temporary benefits payable until Social Security normal retirement age.

Under the changes we have adopted, all company stock matching amounts are fully diversifiable.

INFORMED CHOICE PROCESS

After deciding on the design, and to give existing employees choice, we had to ensure that the new plan and the choice were communicated clearly to all affected participants. For the recently acquired Aeroquip Vickers employees, who would be receiving a new pension for the first time since joining Eaton, we issued Summary Plan Descriptions, held onsite meetings, and created a Web site where employees could model future EPPA benefits under a variety of economic assumptions.

For the choice process, we drafted written communication materials with the intent of satisfying—and, in fact, exceeding—ERISA section 204(h).[10] Each employee received a detailed Decision Guide, an individualized Personal Choice Statement, and an easy-to-read Quick Comparison Chart. In developing these materials, we kept in mind the high standard that had been set by Kodak—whom Senator Moynihan publicly cited as the "gold standard" for hybrid conversion communications—during its choice process, and strived to meet or exceed it. In addition, we made continual use of employee focus group feedback to refine these materials.

The Decision Guide explained, in detail, the features of the participant's existing traditional plan and the EPPA, including details regarding the calculation of the opening balance. This document displayed charts of both options—the current plan and the EPPA—and how they compared at future ages under a certain set of assumptions, using hypothetical examples. In addition, we explained the concept of wear-away,[11] and graphically described the effect it could have on employees. The Quick Comparison Chart was a side-by-side comparison of the main provisions of each option. We should note that Eaton's approach minimized the effect of wear-away. The inclusion of early retirement supplements and subsidies in employees' cash balance opening accounts, as well as the effect of indexing credits, mitigated the effect of, and shortened the duration of, wear-away in most cases. In fact, often it was the inclusion of early retirement supplements in the value of the protected benefit under the existing traditional design—a pro-employee change that is not required by law—that caused an appearance of wear-away.[12]

The Personal Choice Statement used actual individualized participant data so that each employee could compare their estimated future benefit accruals under each option, under a certain set of assumptions. The data used for these statements was audited in advance of, and in anticipation of, this project. In particular, each of the 15,000 eligible employees was asked to review and confirm or correct their work history so that accurate service data was used for any estimate.

After the written materials were sent out, we held over 250 educational meetings and web casts at all 100 U.S. and Puerto Rico locations. Spouses and financial advisors of employees were also invited to attend these meetings, which were led by independent third party pension experts.

We also developed a Web site where employees could model individualized scenarios based on their own differing economic assumptions, including salary in-

[10] Section 204(h) of ERISA requires employers to provide advance notice of amendments to defined benefit plans that provide for a significant reduction in the rate of future benefit accrual. Congress amended section 204(h) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 to require employers to provide a more detailed and more understandable notice of any hybrid conversion or other plan amendment that significantly reduces future accruals. This reflected Congress' view that the appropriate response to the issues that had been raised about cash balance conversions was to ensure transparency rather than to impose benefit mandates on employers. The Treasury Department has subsequently issued regulations carrying out this expanded notice requirement. Notice of Significant Reduction in the Rate of Future Benefit Accrual, 68 Fed. Reg. 17,277 (Apr. 9, 2003) (to be codified at 26 C.F.R. pts. 1, 54, and 602).

[11] Wear-away is the benefit plateau effect that some employees can experience incident to a cash balance conversion. When employers change to a cash balance plan, they typically provide an opening account balance in the cash balance account. A benefit plateau results if the value of the employee's cash balance account is less than the value of the benefit he accrued under the prior plan as of the time of the conversion. Until the value of the cash balance account catches up to the value of the previously accrued benefit, it is the higher accrued benefit to which the worker is entitled—hence the term "plateau." This benefit plateau typically results from the fact that the prior accrued benefit includes an early retirement subsidy while the opening account balance does not. It should be noted that wear-away has long been approved by the Treasury Department and Internal Revenue Service as a valid method for transitioning between benefit formulas.

[12] Those employees who experienced a wear-away as part of the conversion process did so only because they chose the new cash balance formula, concluding that even with some period of wear-away the new cash balance design was best for them.

creases and interest rate assumptions. In addition, the Choice Website contained all the educational information that was included in the written materials.

If employees had questions, they could call the Pension Choice Helpline, where independent third party pension experts answered questions about the different plans and ran individualized comparisons on the spot. If there was a question that the Pension Choice Helpline representatives could not answer, we made sure the employee was connected to someone at Eaton who could answer his or her question.

If an employee did not make a choice, he or she remained in his or her existing traditional plan. In addition, we permitted employees to make a one-time change in their initial choice during a "grace period."

THE RECEPTION

At the end of the day, we wanted to make sure that all participants had enough information to make an informed choice. Based on the overwhelmingly positive reaction we received from employees, we believe we accomplished that goal.

Across the board, employee reaction was very positive regarding the pension choice process. The vast majority of employees said that the materials provided helped them make an informed decision. In fact, employee feedback indicates that this process helped employees understand their existing traditional pension plan as well as the new cash balance option. In addition, we received many comments that this process only strengthened the trust that existed between Eaton and its employees. We received no letters of complaint and encountered no disruption in daily business operations during the conversion process.

In the end, about one-third of eligible employees chose the EPPA. The breakdown by age and service went as expected. Of the employees more than 20 years away from retirement, over 60 percent elected to switch to the EPPA. Of the employees at retirement age or within 10 years of retirement, over 80 percent elected to remain in their existing traditional pension plan. However, there were several instances where, after modeling personalized scenarios and reviewing examples in the Decision Guide, employees close to or at retirement eligibility chose the EPPA. It was not unusual for the EPPA to provide a greater benefit for a retirement-eligible employee some years in the future, largely due to the inclusion of early retirement supplements and subsidies in the opening balance and the application of indexing credits. Had we kept these employees in their current pension design, we would have deprived them of a chance to increase their pension benefit, even at a point late in their careers. Of the employees between 10 and 20 years from retirement, over 40 percent switched to the EPPA.

I was in the "in-between" group mentioned above, and although I chose to remain in the existing traditional plan, both benefit designs had distinct advantages depending on my expectations regarding my future career path. Before joining Eaton, I worked at a company where I participated in a cash balance plan for 12 years. As a mid-career hire at Eaton, and as a full-time working mother, it's important to me to have retirement benefits that fit my needs. The employee reaction to Eaton's decision to implement a cash balance plan and provide an informed choice was overwhelmingly positive. This, along with similar data from numerous surveys, indicates that employees understand and appreciate the need for companies to have flexible retirement programs that fit the needs of today's workforce.

All in all, the choice process set a new standard at Eaton for communicating change throughout the company. However, we recognize that choice may not be the right answer for other businesses and other employee populations, and under different circumstances, it might have been the wrong answer for Eaton. Some employers, for example, have focused on grandfathering employees or pursuing a "greater of" approach rather than asking their employees to choose between the plans. Other companies, while scrupulously protecting benefits already earned (as current law requires), have been limited by economic circumstances in the degree of special transition benefits they can provide.

Our Coalition believes it would be extremely unwise to mandate particular transition techniques for future conversions, as some in Congress have proposed to do, since a broad range of methods is available to ensure that employees are treated fairly in the transition process. One mandated conversion method—or even several—would deny employers needed flexibility to customize their transition approaches to their particular workforce. Such conversion mandates—to pay the greater of the traditional or hybrid benefits or to offer choice, for example—also provide employees with a guaranteed right to future benefits that have not yet been earned.

These mandates would represent a disturbing shift in the basic norms of American industrial relations. Employee hopes or expectations as to future benefits would be converted into explicit legal entitlements. This profound change from existing

principles suggests that the terms and conditions of a worker's employment may not be revised from those in existence at the time the employee is hired. Such a regime would rob employers of the ability to adapt to changed circumstances and would undermine the business flexibility on which America's prosperity and robust employment are built. Presumably, policymakers would not restrict employers from being able to alter—on a prospective basis—their 401(k) match level or the design of their health plan—but this is exactly the kind of restriction that mandated conversion techniques impose. Our Coalition sees no end to the harm if Congress goes down the path of converting expectations into legal rights. Certainly, employers will be extremely reluctant to institute any new benefit programs in the future, and those employers that today do not offer pension or health plan coverage for their employees will be extremely unlikely to do so.

THE COST

It is very important to note that Eaton did not introduce a cash balance plan to reduce costs. In fact, the long-term ongoing cost of the EPPA is slightly higher than the steady-State costs of the prior pension plan designs. In addition, we incurred higher short-term costs due to the fact that most participants maximized their benefits, and therefore the cost to Eaton, when they made their individual pension choice. Outside of direct plan costs, Eaton spent several million dollars in the overall choice effort, including consulting fees, communication materials and pension modeling tools, as well as lost work hours due to employee meetings.

Based on press accounts about cash balance conversions, one might expect that Eaton's cost experience is atypical. This is not the case. Recent surveys confirm that conversions to hybrid plans typically increase costs. Recent data from a Watson Wyatt Worldwide study examining 55 large companies that have recently converted from traditional defined benefit plans to hybrid plans shows that retirement plan costs increased by an average of 2.2 percent following a conversion.[13] This figure further increased to 5.9 percent when seven companies that were in severe financial distress were excluded from the pool.[14]

THE RAMIFICATIONS IF CONGRESS DOES NOT PROVIDE CLARITY

If Congress does not move quickly to provide legal certainty for hybrid plans, many Americans may soon lose valuable retirement benefits. The current legal landscape is ominous. One rogue judicial decision has made the threat of age discrimination class action litigation a very real concern for employers with hybrid and many other forms of defined benefit plans.[15] This is no longer a mere theoretical threat as numerous employers with hybrid plans have now been sued in copy-cat class action suits alleging that the very design of their hybrid plans is age discriminatory.

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[13] WATSON WYATT WORLDWIDE 2004, supra note 5 at 3.

[14] *Id*. In addition, conversions are often accompanied by improvements to other benefit programs, such as 401(k) plans, bonuses, and other post-retirement benefits. In fact, one recent survey found that when these improvements are taken into account, 65 percent of respondents expected the costs of providing retirement benefits following a cash balance conversion to increase or remain the same. MELLON FINANCIAL CORPORATION, supra note 5 at 15. Another survey, conducted in 2000, also found that overall costs following a conversion were expected to increase or remain the same in 67 percent of the cases. PRICEWATERHOUSECOOPERS, CASH BALANCE NOTES 4 (MAY 2000).

[15] This decision, *Cooper* v. *IBM* Pers. Pension Plan, 274 F. Supp. 2d 1010 (S.D. IL 2003), held that the cash balance and pension equity hybrid designs were inherently age discriminatory. The court concluded that such pension designs violate the pension age discrimination statute, which provides that the rate of a participant's benefit accrual may not decline on account of age. The court interpreted the pension age discrimination statute to mean that the amount of annuity benefit received at normal retirement age for a period of service (e.g., 1 year) cannot be less for an older worker than a younger worker. Such a conclusion is clearly contrary to the basic "time value of money" principle that a younger worker will have a longer period of time to accrue interest, and thus will have a larger benefit amount at retirement based on an equal contribution today. Under the *Cooper* decision, any pension plan that contains a compound interest feature is inherently age discriminatory. This misguided logic not only impugns hybrid plans, but also contributory defined benefit plans (common among State and local Government employers), plans that are integrated with Social Security, and plans that provide indexing of benefits to guard against inflation. All other Federal courts that have addressed this issue, including those that have handed decisions down subsequent to the *Cooper* case, have reached the opposite conclusion and indicated that the cash balance design is age appropriate. *Tootle* v. *ARINC*, Inc., 222 F.R.D. 88 (D. Md. 2004); *Campbell* v. *BankBoston*, N.A., 206 F. Supp. 2d 70 (D. MA 2002); *Eaton* v. *Onan*, 117 F. Supp. 2d 812 (S.D. IN 2000). See also *Godinez* v. *CBS Corp*., 31 Employee Benefits Cas. (BNA) 2218 (C.D. CA 2002), afff'd, No. 02-56148, 2003 U.S. App. LEXIS 23923 (9th Cir. 2003); *Engers* v. *AT&T*, No. 98-3660 (D. NJ June 6, 2001). Nonetheless, a number of employers have now been sued for the alleged discriminatory nature of their plan design based on the *Cooper* decision.

Asserted damage claims in these suits reach astronomical figures—into the hundreds of millions and even billions of dollars—and the potential amounts of these awards continue to grow the longer the plans remain in effect. In Eaton's case, the cost to modify our plan for alleged "age discrimination" in its design would curtail our ability to commit funds for other important functions, such as for research and development—and this is for a plan that has not yet been in existence for 4 years!

Beyond the cost in dollars, there would be increased complexity in the administration of our benefit programs and the programs would be harder to understand should we have to "correct" for the natural effect of compound interest. Moreover, any change to our well-received conversion process would greatly disrupt our day-to-day business operations. If a remedy would require Eaton to redo the choice process, there would be even more confusion, complexity and business disruption. Worst of all, there would be a huge impact on employee morale and employee trust. Eaton prides itself on building trust with its employees, and we believe that the cash balance conversion experience strengthened that trust.

Like the majority of other employers who switch to a cash balance design, Eaton made every effort to act in "good faith" during our conversion. As opposed to adopting a less costly, less secure and less controversial defined contribution design, Eaton incurred additional cost through the conversion process, provided a variety of communications materials and tools, used a fair conversion method, and minimized the effects of wear-away.[16] Without legislative clarification that our cash balance design is age appropriate, the efforts we made to align our benefit structure with our business needs, while at the same time enhancing benefits for and strengthening trust with our employees, will have been wasted.

In today's economic climate, prudent business leaders seek to minimize corporate risks not associated with the company's core business. As you are aware, sponsorship of a defined benefit plan of any variety entails a number of costs and uncertainties for a company, and such costs and uncertainties are likely to increase in the coming months as a result of legislation to reform the pension funding rules and increase the premiums employers pay to the Pension Benefit Guaranty Corporation. The very real litigation risks hybrid plan sponsors face today are over and above these extremely significant costs and uncertainties accompanying defined benefit plan sponsorship generally. Absent congressional action to mitigate the specific risks associated with hybrid plan sponsorship, business leaders will likely be forced to terminate or freeze hybrid pension plans in order to limit exposure to class-action litigation with 9 or 10 figure damage awards. Indeed, in light of these litigation risks, a number of large U.S. employers have already frozen their hybrid pension plans in recent months, deciding to no longer offer any sort of defined benefit pension program to their new hires. It should be noted that the bulk of employers that have moved to hybrid plans have concluded that the traditional pension design no longer meets the needs of large numbers of their current and future employees. Thus, these employers are extremely unlikely to return to a traditional defined benefit plan after freezing or terminating their hybrid plan. The recent freezes by large employers bear this out. The unfortunate freezes and terminations of recent months will only become more widespread should legislative resolution of the hybrid issues take longer.

Why must Congress be the one to act to clarify the validity of the hybrid designs? First, Congress has indicated through the appropriations process that it does not want these important policy issues being determined by the Federal regulatory agencies. As a result, the Treasury Department has withdrawn its proposed regulations addressing hybrid plans and age discrimination principles, which had the potential to settle the open issues regarding hybrid plans. Second, final resolution of the age discrimination question by appellate courts is years away at a minimum, too late to address the litigation risks that are beginning to drive employers from hybrid plans and the defined benefit system. Neither are the courts the appropriate forum to consider the broad public-policy ramifications (for employees and their families, for employers, and for our Nation's retirement policy) of holding the cash balance and pension equity designs to be age discriminatory.

In order to prevent widespread abandonment of hybrid plans by employers—and the loss of retirement security this would produce for millions of American families—Congress must clarify that the cash balance and pension equity designs are age appropriate under current law. Congress should also provide legal protection for the hybrid plan conversions that have already taken place in good faith reliance on the legal authorities operative at that time. Finally, should Congress decide to es-

[16] As noted above, while Eaton was able to provide a generous "choice" conversion, it is by no means the only suitable method by which employers can change benefit designs and does not reflect the business realities for all companies.

tablish rules to govern future conversions, our Coalition strongly recommends that it avoid the mandates guaranteeing future benefits that will merely accelerate employers' departure from the defined benefit system.

Resolving the hybrid pension issues appropriately is particularly urgent given the many challenges American families face in achieving retirement security. With Social Security facing solvency problems that could well result in benefit reductions, with personal savings rates at near-historic lows, with employees bearing significant market risk in 401(k) and other defined contribution plans, with retiree medical costs continuing to soar and with life expectancy continuing to increase, now is precisely the wrong time to encourage employers to depart from the hybrid pension plans that provide guaranteed, employer-funded retirement benefits in a way that suits today's mobile workers. Yet this is precisely what will occur if Congress does not act.

CONCLUSION

Mr. Chairman, I want to thank you once again for calling this hearing. Legislation is the only effective way to address today's uncertainty surrounding hybrid pension designs and prevent further erosion of the retirement benefits of American families. Our Coalition looks forward to working with you and members of the committee to achieve this objective.

Thank you, again, for the opportunity to appear today. I would be pleased to answer any questions you may have.

The CHAIRMAN. Mr. Certner?

Mr. CERTNER. Mr. Chairman, Senator Mikulski and members of the subcommittee, I am David Certner, the Director of Federal Affairs of AARP. Thank you for the opportunity to testify on the important legal and policy issues surrounding older workers and cash balance plans.

While cash balance plans are often called hybrid plans, they are defined benefit plans under the law, and they must therefore follow all the rules for defined benefit plans. AARP has long questioned the legal basis for cash balance plans because these plans cannot fit within all the defined benefit plan rules. Also, there are significant age discrimination questions that arise when employers convert a defined benefit plan to a cash balance formula. Treasury and the IRS recognized these problems when they placed a moratorium on conversions in 1999.

We believe that regardless of what one thinks of the cash balance design, that a careful review of the legal distinction between defined benefit and defined contribution plans, makes clear that hybrid cash balance plans do not fit within the current legal framework. The recent court decision in *Cooper* v. *IBM* agreed that cash balance plans do not fit within current law.

But we urge this committee to address the legal framework for cash balance plans, and at the same time provide strong and effective protections for older workers involved in cash balance plan conversions.

Traditional defined benefit plans typically provide only small benefits early in a worker's career and larger benefits later in the career for those who devote much of their working lives to the company. It is therefore unfair for employers that have sponsored this type of plan to eliminate these promised, larger late career benefits, just when longer-serving workers are about to obtain them. But that is precisely the damage caused by conversions of traditional pensions to cash balance plans unless older workers are given appropriate transition relief to address this pension pay cut, in essence that is brought about by conversions.

Planned conversions change the rules in the middle of the game, and older, longer service workers have the most to lose. They generally lose out on the larger late-career benefits. They have less time to accumulate benefits under the new cash balance formula, and they are less able to leave their current job if benefits are cut because they typically have fewer job prospects.

Worker outrage, adverse publicity and legal concerns have increasingly caused plan sponsors converting to cash balance plans to recognize the harm to older workers and to put in place protective transition provisions, just as we have heard from my colleague here at the panel. We urge Congress to, in effect, codify the better practices that many employers have already adopted in order to protect older workers and cash balance conversions.

AARP believes that cash balance plans can have a role to play in the private pension system if and only if they are designed and adopted in a manner that protects the millions of older workers who have given up their wages in exchange for the traditional defined benefit promise.

Provided that these protections for older and longer-service workers can be adopted, AARP would support the enactment of a reasonable legislative solution that would provide the legal certainty for cash balance plans. Right now it's not good for either employers or employees to be operating under an uncertain legal framework.

However, Congress should not legitimize conversions that many employers themselves have found to be unfair and harmful to older employees. One such unfair—and again, we believe—illegal practice because it is based on age, is the so-called "wear-away." Wear-away simply means the time it takes for the new plan formula in essence to catch up to the guaranteed benefits under the old plan formula. Wear-away is in effect a period of time when no new benefits can be earned and that can last for over 10 years of time. Employers have recognized this problem and many have taken steps to preclude wear-away. AARP commends the most recent Treasury Department proposal to ban any type of wear-away, and we urge Congress to do the same.

Many employers have also sought to address the large future pension cut that is experienced by older workers by giving them choice or by grandfathering older workers in the traditional plan formula. These and other protections have now raised the bar with respect to cash balance conversions in the private sector. In any effort to clarify the law, Congress should not now lower the bar by enacting weakening legislation that invites the market to return to the lower standards of the 1990s. Instead, Congress needs to hold all companies that voluntarily choose a cash balance plan to a standard that many companies have been willing and able to meet on their own.

The cash balance format deserves protection from legal challenge only if it protects older workers from the harm caused by moving to that structure.

We look forward to working to finally resolve this issue through legislation that will strengthen the defined benefit system and protect older workers and address the legal uncertainties surrounding cash balance plans.

Thank you.

[The prepared statement of Mr. Certner follows:]

PREPARED STATEMENT OF DAVID CERTNER

SUMMARY

1. AARP believes cash balance plans have a role to play in the private pension system if—and only if—they are designed and adopted in a manner that protects the millions of older workers who have given up wages in exchange for traditional defined benefit pensions. Provided that protections for older and longer-service workers can be adopted, AARP could support the enactment of a reasonable legislative solution that would provide legal certainty for cash balance plans.

2. Traditional defined benefit pension plan designs typically provide only small benefits early in a worker's career, and larger benefits later in the career for those who devote much or all of their working lives to the company. It is therefore unfair for employers that have sponsored this type of plan for years to pull the rug out from under older workers by eliminating these promised larger, late-career benefits just when long-serving workers are about to obtain them. Yet that is precisely the damage caused by conversions of traditional pensions to cash balance plans—unless older workers are given appropriate transition relief to address the impact of the "pension pay cut" brought about by conversions.

3. When conversions change the rules in the middle of the game, older, longer-service workers are the most vulnerable. They generally have less time to accumulate benefits under a new cash balance formula, are less able to leave their current job if benefits are cut because they typically have fewer job prospects, and are less able to adjust to changes that may dramatically reduce their retirement security (for example, they have less time to adjust by increasing their saving for retirement).

4. Worker outrage, adverse publicity and legal concerns have increasingly caused plan sponsors converting to cash balance plans to recognize the harm to older workers and to put in place more protective transition provisions. Congress should, in effect, codify the better practices many employers have already put in place in order to legitimize cash balance plans and protect older workers.

5. However, Congress should not legitimize conversions of a type that many employers have themselves found to be unfair and harmful to older, longer-service employees. The steps many employers have taken in conversions to preclude wearaway of benefits and to give older workers "choice" or "grandfathering" in the traditional plan formula and other protections have raised the bar with respect to cash balance conversions. Congress must not now lower the bar by enacting weakening legislation that invites the market to return to the lower standards of the 1990s. Instead, Congress needs to hold all companies that voluntarily choose to convert to a cash balance plan to a standard many companies have been willing and able to meet on their own.

6. The cash balance format deserves protection from legal challenge only if it protects older workers from the harm caused by moving to that structure. We look forward to finally resolving this issue through legislation that will strengthen defined benefit pension plans, protect older workers, resume the IRS determination letter process, and address the legal uncertainty surrounding cash balance plans.

Chairman Dewine, Ranking Member Mikulski, distinguished members of the subcommittee, I am David Certner, Director of Federal Affairs, of AARP. AARP is a nonprofit membership organization of over 35 million persons age 50 or older, about 45 percent of whom are still working. AARP fosters the economic security of individuals as they age by seeking to increase the availability, security, equity, and adequacy of pension benefits. AARP and its members have a substantial interest in ensuring that participants have access to pension plans that provide adequate retirement income and that the benefits accrued under a plan are not reduced because of age.

I. WHAT ARE CASH BALANCE AND OTHER HYBRID PLANS?

Congress provided a detailed structure in defining retirement plans under ERISA[1] and the Internal Revenue Code ("IRC"). All retirement plans are either defined benefit plans or defined contribution plans, even if they have features of both. A defined contribution (or "individual account") plan provides an individual account for each participant, with the benefits at retirement consisting of contributions the

[1] The employee Retirement Income Security Act of 1974, as amended.

employer and employees have made, plus income and gains, and minus expenses, losses, and forfeitures. [ERISA section 3(34)]. A defined benefit plan is defined as any retirement plan other than an individual account plan. [ERISA section 3(35)]. Traditionally, the benefit at retirement under a defined benefit plan is based on a benefit formula that takes into account years of service and, under many plans, final salary or wages.

Recognizing that defined contribution plans and defined benefit plans—and their methods of accruing or accumulating benefits—are fundamentally different, Congress prescribed a different set of rules for each (including rules governing the timing of benefit accruals, valuation of benefits, certainty of benefit determinations, and expression of accrued benefits).[2] A plan sponsor may not pick and choose which rules to follow, but must follow all the rules depending upon the plan design selected.

Cash balance pension plans (and other plans, such as pension equity plans) are so-called "hybrid" plan designs.[3] Cash balance plans are defined benefit plans that have been designed to resemble defined contribution plans. Instead of presenting the benefit in terms of an annuity payable at retirement, as traditional defined benefit plans do, cash balance plans portray a participant's benefit as a lump sum amount that increases over time, and, in practice, pay most benefits in the form of lump sums.

In most cash balance plans, the benefit is defined by reference to a "hypothetical account." The hypothetical account is credited with an annual pay credit (usually a percentage of pay, such as 5 percent of pay each year) plus a hypothetical rate of return (usually tied to an index, such as a Treasury bond rate) on the account balance (an "interest credit"). As in all defined benefit plans—and consistent with the hypothetical nature of these "individual accounts"—the employer contributes assets to the plan, the assets are invested for the plan as a whole instead of earmarking particular assets or investments for the individual accounts of particular participants, the employer (including those to whom it delegates) manages the plan, and the employer is permitted flexible funding. This means that, at any given time, there may be more benefits promised in the hypothetical accounts than there are assets in the plan.

The employer's contribution obligation depends upon its estimate of the present value of total future benefit obligations and its investment gains and losses, not on fixed or promised annual contributions to individual accounts. Employers generally benefit from the "spread" between what the employer promises in interest credits and what the plan actually earns (the interest arbitrage) while assuming the investment risk if asset returns are less than needed to pay promised benefits. Since defined benefit plan rules allow for flexible funding, any investment shortfall can be made up over several years.

AARP also has long questioned the legal basis for the hybrid cash balance formula itself (in addition to the significant age discrimination issues that arise when employers convert defined benefit pension plans to a cash balance formula). We believe that a careful review of the legal distinction between defined benefit and defined contribution plans makes clear that the most common designs for hybrid cash balance plans do not fit within the current legal framework of the Internal Revenue Code (IRC), the Age Discrimination in Employment Act (ADEA) and ERISA (see Appendix A). In fact, the recent court decision in *Cooper* v. *IBM* agreed with this legal analysis. We urge the committee to address the legal framework for cash balance plans and provide strong and effective protections for older workers involved in cash balance pension plan conversions.

II. CONVERSIONS OF TRADITIONAL PLANS TO CASH BALANCE PLANS

The growth of cash balance plans has resulted mainly not from new plan formation but from conversions of existing traditional defined benefit plans. Employers have converted to cash balance and other hybrid plan designs for a number of reasons, including a desire to reduce plan costs and limit future pension obligations as the bulge of "baby boomers" nears retirement and hence moves through the years of greatest pension cost to employers (and greatest pension value to employees); to increase employee appreciation (since many employers believe employees do not well understand or appreciate the traditional defined benefit plan); to eliminate costly early retirement subsidies and final average pay features; to increase pension sur-

[2] Where the statute does permit a mix of defined benefit and defined contribution rules, it so specifies, as in the case of one type of pension—target benefit plans.

[3] In the interest of simplicity, this testimony limits the discussion to the most common type of hybrid defined benefit pension plan, the cash balance plan.

pluses that, in the 1990s, often contributed to reported corporate earnings; to redistribute benefits under the plan from older, longer-service employees to younger and newer workers; and to achieve these objectives without terminating the defined benefit plan and adopting a new defined contribution plan, which often would entail income and excise taxes and would terminate the interest arbitrage.

In general, the direct and immediate result of a conversion of a traditional plan formula to a cash balance formula is a reduction in future benefits for older workers. A 1998 survey by the Society of Actuaries found that in cash balance conversions, the average benefit reduction for an older employee was 70 percent to 85 percent of 1 year's wages, but younger workers saw a benefit increase of 10 percent to 40 percent of 1 year's wages.[4] Moreover, the actuaries that design cash balance plans have been on record acknowledging that conversions to cash balance formulas "help employers cut pension benefits and change retirement plans," especially for older workers. *Ellen E. Schultz, Actuaries Become Red-Faced Over Recorded Pension Talk*, Wall St. J., May 5, 1999, at C-1. Indeed, plan actuaries have at times bluntly acknowledged this reality.[5]

III. HOW CONVERSIONS HARM OLDER WORKERS: THE PENSION PAY CUT THAT BREAKS THE PENSION PROMISE

A. The General Adverse Impact on Older Workers from Conversion to a Cash Balance Pension Plan.

For employees, the change in plan design from a traditional defined benefit pension plan to a cash balance plan can have significant impact. For older workers, absent transition relief, it is almost always highly detrimental, amounting to a significant "pension pay cut."

By depriving older workers—especially long service older workers—of the benefit of their increased years of service and their peak earning years (including any early retirement subsidies), employers who make this dramatic change break the implicit promises made to older workers in the traditional defined benefit pension plan. These employees have given up wages and may have made career and retirement decisions based upon the expectation of a certain pension benefit, only to see that expectation disappear—replaced by the new cash balance plan formula under which their age precludes them from earning comparable benefits.

In addition, some older workers may suffer a wear-away period—a period of time when no new benefits are accrued under the new plan. Older workers thus experience a double whammy—loss of the more beneficial defined benefit formula, as well as the lack of time to benefit from the new plan formula (with the potential for no new benefits at all).

B. The Specific Adverse Impacts on Older Workers from Conversion to a Cash Balance Pension Plan.

The conversion to a cash balance plan adversely affects older, longer service workers in at least four ways:

1. Conversion deprives older workers of the benefits derived from long service and a higher salary they would have received in the traditional defined benefit plan.

A traditional defined benefit plan often has a benefit formula that is based on number of years worked and final average salary. In addition, the annuity value is determined by number of years from retirement age, with greater value for those closest to normal retirement age. This final average pay benefit formula design provides smaller value in the early years of employment, with the greatest value coming in the last years of employment.

Because this plan is designed to benefit longer service workers, older workers generally can accrue larger benefits under this traditional type of formula, especially if they are long-service workers. Younger, more mobile workers receive less from this plan design. A younger worker covered by a traditional formula, in addition to being many years from retirement age, generally has a lower salary and a smaller number of years of service. The result is a small benefit after only a few years of work. As one begins to approach retirement age, and as one's salary and number

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[4] *Id.* at 18.

[5] In an illuminating exchange, Amy Viener, an actuary at William M. Mercer, Inc., responded to an inquiry about whether cash balance plans reduce benefits: "Converting to a cash-balance plan does have an advantage as it masks a lot of the changes. . . . You switch to a cash balance plan where the people are probably getting smaller benefits, at least the older-longer service people, but they are really happy, and they think you are great for doing it. . . ." *Id.* at C-19. A co-panelist of Ms. Viener's at another meeting stated, "It is not until they are ready to retire that they understand how little they are actually getting." Ms. Viener responded, "Right, but they're happy while they're employed." *Id.*

of years in the plan increase, benefits begin to grow more dramatically. The bulk of benefits can be expected in the years just prior to retirement.

2.Conversion deprives older workers of early retirement subsidies often provided in traditional plans.

The effect of increasing age and higher salary can be magnified by eligibility for an early retirement subsidy. Many traditional defined benefit plans include such a subsidy, generally based on a combination of number of years of service and age. Older employees who become eligible for these subsidies can see an additional spike in the value of their pensions. Conversions commonly eliminate these subsidies.

3. Depending upon the conversion formula, older workers may be subject to a significant wear-away, causing them to work for many years before earning any additional retirement benefits.

Compounding the adverse impact of the change in benefit formula, the benefits under the new plan, in essence, may take many years to catch up to the benefits already earned under the old plan formula. During this catch-up period, the employee would accrue no new benefits. This freeze of pension accruals stands in sharp contrast to employees' expectation that their final years of service would result in the greatest increase in their retirement benefits.

Such a wear-away can occur if the employer designs the conversion to give employees an ultimate pension benefit equal to the greater of (i) their old formula benefit (earned based on service before the conversion and fixed as of the conversion) and (ii) their cash balance earned under the new formula. Under this "greater-of" approach, as long as the frozen old formula benefit exceeds the new formula benefit, the participant is not actually earning any additional benefits under the plan. The participant's total benefit is effectively frozen after the conversion until the new formula benefit grows larger than (wears away) the old. This could take 10 years or more. In the meanwhile, older participants suffer an age-based cessation of accruals.

A wear-away can affect participants who retire early as well as those who retire at the "normal retirement age" (typically 65). This is especially true if the old benefit formula provided a subsidized early retirement benefit before the conversion. In such a case, a participant who qualifies for the early retirement subsidy (before or after the conversion) might experience a period of years after conversion in which continued service for the plan sponsor generates no net increase in the early retirement benefit. This freeze of early retirement accruals would continue for as long as the new-formula (cash balance) benefit the participant would receive at early retirement age remains less than the old-formula benefit she would receive at that age.

Older participants commonly will have more to lose from wear-away of subsidized early retirement benefits than from wear-away of the normal (typically age 65) retirement benefit. There may be more dollars at stake, and most employees retire before age 65.[6]

Wear-away is neither required nor necessary in a conversion. In any event, because wear-away is always based in part on age, it runs afoul of the prohibitions against age discrimination. A plan sponsor can, and often does, prevent wear-away by providing that the ultimate plan benefit is the sum of the participant's benefits accrued under the traditional plan (the old formula frozen benefit) and the cash balance formula. (This is often referred to as the "sum-of" or "A+B" approach.)[7]

4.Older workers are disadvantaged because they have fewer years in which to accumulate significant pension amounts under the cash balance formula.

A typical cash balance formula provides for a much larger accrual of benefits at an earlier age than a traditional defined benefit plan. Since a younger employee has a longer period of time before normal retirement age, the amount in the plan's hypothetical account will continue to earn interest credits for a much longer period of time, leading to greater benefits. Fewer years until normal retirement age means older workers have less compounding and thus smaller benefits.

As a result, the conversion to a cash balance formula has the practical and substantive effect of often dramatically reducing or ceasing accruals to the pensions of older and/or long service workers. Older employees have reported reductions in their expected benefits in the tens and even hundreds of thousands of dollars. In contrast, younger mobile workers, who had accumulated little under the prior plan design, may see a higher accrual rate.

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[6] For more information on preventing wear-away of early retirement benefits, see Appendix B.

[7] Because calculation of a wear-away following a conversion is based directly on age, it violates the pension accrual laws. ADEA section 4(i). While age is not the only element in determining wear-away, it is an essential element in determining the actuarial equivalence of the earned benefit. See Appendix A.

In the early years of the traditional plan, an employee receives small benefits in return for the promise of greater benefits as the employee continues to work. The change in plan design to a cash balance plan undermines completely that benefit trade-off. Older workers find that having completed those years in the traditional plan when benefits were small—and having now reached the stage when benefits will begin to grow considerably—the conversion to the cash balance plan deprives them of those expected higher benefits. These conversions give new meaning to the term "sandwich" generation.

The pension laws generally prohibit plans from reducing accrued benefits that an individual has previously earned. However, the law does not require an employer to continue any particular plan design, nor indeed even continue any plan, into the future. The conversion to a cash balance plan uses this permissive nature of our voluntary pension system in a way that undermines the expectations of employees. Despite having worked for years under a plan design that gave small benefits at the beginning but promised higher benefits at the end of one's career, the same employees are suddenly switched to a pension package that provides the very opposite. Unlike reductions in benefit formulas in which everyone may feel the pain equally, a conversion to a cash balance plan (absent special transition relief) produces clear winners and losers (the losers being the older, longer-serving employees). And, in some cases, this has been done in a manner that has masked the actual negative effects (as discussed earlier), at least for a time.

IV. WEAR-AWAY IN A CONVERSION IS AGE DISCRIMINATORY

The wear-away period often associated with cash balance conversions—the period of time after the conversion when no benefits are earned—is an unlawful and impermissible reduction or cessation in benefit accruals based on age. Because calculation of a wear-away following a conversion is based directly on age, it violates the pension accrual laws. While age is not the only factor in determining wear-away, it is always an essential element. See Appendix A.

V. BETTER PRACTICES BY PLAN SPONSORS

The harm to older workers caused by cash balance conversions has given rise to outrage on the part of older and longer-service employees who have been affected and a higher level of awareness by other employees, including those potentially affected by future conversions. (In some cases, employee anger has been exacerbated by the fact that some conversions have imposed painful reductions in future benefits—including wear-aways on older workers—even when the plan had substantial surplus assets, and the gains in pension surplus associated with this "pension pay cut" were used to improve reported corporate earnings and consequently increase performance-based executive pay). The damage caused by conversions that pulled the rug out from older and longer-serving employees has also generated considerable adverse publicity, public and employee relations problems for plan sponsors, and major court challenges to the legitimacy of cash balance plans and practices.

As controversy erupted over cash balance conversions, the Internal Revenue Service in the fall of 1999 suspended its issuance of determination letters approving cash balance plan conversion amendments. Treasury and IRS announced that they were reviewing the age discrimination and associated legal issues raised by conversions, and received hundreds of public comments.

This controversy and related developments convinced many plan sponsors to address the transition problems raised by conversions. While conversions in previous years were often unprotective, many employers have more recently addressed the transition issue by providing relief to their older, longer-service workers. More and more companies—fearful of negative media attention and the reaction of a more knowledgeable workforce, and concerned that their actions might be age discriminatory or otherwise unlawful—have designed more and better transition protection. This protection has come in a number of forms. Many companies have simply permitted their older employees the option of staying under the old formula, while others have automatically grandfathered older and/or longer-serving employees in the old formula. Some, like CSX, whose CEO at the time was Treasury Secretary John Snow, did not apply the conversion to any existing employees. Other companies have provided added benefit protections such as significantly higher pay credits or opening balances for older workers. In short, many in the private sector have responded to the problems with cash balance conversions by raising the bar for transition protection.

VI. ACTIVITY IN THE EXECUTIVE BRANCH, CONGRESS, AND THE COURTS

In December 2002, Treasury and IRS proposed regulations that would have given a green light to plan sponsors to again convert their traditional plans to cash balance plans without adequate protection for employees. (67 Fed. Reg. 76123). The proposed regulations would have protected the cash balance design under the age discrimination and other statutory provisions without adequately protecting participants. The regulations had they become final would, in effect, have blessed conversions that are not protective—thus plan sponsors would have been less likely to offer their employees choice, grandfather employees in the old plan formula, or use other protective practices that many companies had already adopted. Worse yet, the regulations would have permitted age-based wear-away periods, a practice clearly contrary to the letter as well as the spirit of the age law, and simply bad retirement policy.

In 2003, many thousands of individual contacts regarding the proposed regulations were made to Treasury by workers concerned about the impact of conversions on their pension benefits. (Over 60,000 contacts were made to Treasury and elected officials through the AARP Web site after the proposed regulations were issued). In July 2003, while Treasury was considering comments on its regulatory proposal, a Federal district court ruled that the basic common cash balance plan design impermissibly reduced the rate of benefit accrual on the basis of age and thus violated ERISA's age discrimination provisions (*Cooper* v. *IBM Personal Pension Plan and IBM Corp*., 274 F. Supp. 2d 1010 (S.D. Ill. 2003)).[8] (See Appendix A). IBM appealed the decision to the Seventh Circuit Court of Appeals, where the appeal is still pending.

Following the IBM decision, Congress responded to Treasury's proposed regulations by passing amendments to the Treasury appropriations legislation that, directed Treasury and IRS to stop work on the regulations and instead to put forward a legislative proposal providing transition relief for older and longer-service participants affected by cash balance conversions. In response, Treasury withdrew the proposed regulations[9] and made a legislative proposal (included in the Administration's fiscal year 2005 and fiscal year 2006 budgets). We were pleased that Treasury's legislative proposal recognized the problem with wear-away and the unfair treatment of older workers and recommended a ban on any wear-away of benefits at any time after a cash balance conversion.[10]

In recognition of the transition problem faced by workers, the Treasury proposal also included a 5 year "hold harmless" period after each cash balance plan conversion. This would require that each participant's benefits under the cash balance plan for each of the 5 years after the conversion be at least as valuable as the benefits the participant would have earned under the traditional plan had the conversion not occurred. While the proposal is a step in the right direction, it is not sufficiently protective of older, longer-service workers, and it fails to reflect ongoing trends in the marketplace. In addition, because the transition problem is largely one that impacts older and longer service workers, any proposal can be tailored more narrowly to protect this more vulnerable class of workers. More recent conversions have afforded more protection to older workers. These trends, not adequately reflected in Treasury's proposal, are further confirmation that employers can and should do the right thing for their employees. Instead of lowering the bar, Congress now needs to hold all companies that voluntarily choose to convert to a cash balance plan to a standard that many companies have been willing and able to meet on their own.

One approach that AARP has supported was introduced by Senator Harkin in the 108th Congress. It would require employers that convert to cash balance plans to allow employees who are at least age 40 or have at least 10 years of service the choice to remain under their traditional pension formula until retirement instead of switching to cash balance. In addition, other approaches have been discussed, such as choice or grandfather treatment for employees whose combined age and service exceed a specified number of "points" (e.g., 55).

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[8] Other Federal Courts have ruled differently, holding that the basic cash balance design is not age discriminatory. See Appendix A.

[9] See IRS Announcement 2004–57, in response to Section 205 of the Consolidated Appropriations Act of 2004, Pub. L. 108–199, which prohibited the use of Federal funds to issue any rule or regulation to implement the proposed regulations.

[10] The Treasury proposal would provide that hybrid plans are not age discriminatory and would permit cash balance plans to distribute the participant's account balance as a lump sum provided that the plan does not credit interest in excess of a market rate of return. The proposal states that it is prospective only.

VII. WHAT CONGRESS SHOULD DO NOW

AARP believes hybrid plans have a role to play in the private pension system if—and only if—they are designed and adopted in a manner that protects the millions of older workers who have given up wages in exchange for traditional defined benefit pensions. Provided that protections for older and longer-service workers can be adopted, AARP could support the enactment of a reasonable legislative solution that would provide legal certainty for cash balance plans. Legislative protections should codify the better practices that many employers have already chosen to follow when converting to cash balance, such as eliminating wear-away of early as well as normal retirement benefits and adequate grandfathering or hold-harmless protection for those workers who are vulnerable in conversions. Treasury's proposal is a step in the right direction. However, its 5 year hold harmless period falls short of what would be adequate and of the better practices many employers have followed. At the same time, the more adequate protections could be crafted to preserve flexible options for plan sponsors. Among other things, the protections could appropriately be limited to a narrower class of employees than the Treasury proposal would cover—to those employees whose age and years of service exceed a specified level. In addition, we are open to considering other alternatives that adequately protect older, longer-service employees.

Of course, AARP would oppose legislation that would legitimize hybrid plans that are unfair and harmful to older, longer-service employees. The cash balance structure deserves protection from legal challenges only if it protects older workers from the harm caused by moving to that structure. Now that many employers have recognized the harm and have raised the bar by providing reasonable protections, Congress must not now lower the bar by enacting weakening legislation that invites the market to return to the lower standards of the 1990s. Instead, Congress now needs to hold all companies that voluntarily choose to convert to a cash balance or other hybrid plan to a standard that many companies have been willing and able to meet on their own.

We look forward to working with Congress, the Administration, employees and retirees, plan sponsors, and other stakeholders to forge legislation that will strengthen defined benefit pension plans, protect older workers, resume the IRS determination letter process, and address the legal uncertainty surrounding cash balance pension plans.

APPENDIX A

CASH BALANCE PLANS VIOLATE THE AGE DISCRIMINATION LAWS BECAUSE THE RATE OF BENEFIT ACCRUAL DECREASES ON ACCOUNT OF AGE

Cash balance plans that incorporate a uniform allocation or interest credit rate formula—as they typically do—violate section 411(b)(1)(H) of the Code and the counterpart provisions of the ADEA and ERISA (ADEA section 4(i)[11] and ERISA section 204(b)(1)(H)) because benefits accrue at a lower rate for older employees than they do for younger employees. See *Cooper* v. *IBM Personal Pension Plan and IBM Corp.*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003).[12]

Cash balance plans reduce the rate of benefit accrual based on age in two ways. The first is the age-based reductions in benefit accrual rates inherent in the cash balance formula itself. This age-based decline in accrual rates affects all employees in a cash balance plan. The second is reductions in accrual rates suffered by older workers under the cash balance plan when compared to the old plan (due either to a wear-away or to the lower rate of accrual in the cash balance plan).

Because calculation of a wear-away following a conversion is based directly on age, it violates the pension accrual laws. While age is not the only element in determining wear-away, it is an essential element in determining the actuarial equivalence of the earned benefit. Moreover, declining accrual rates in cash balance plans based on age are the diametric opposite of the often increasing accrual rates in traditional defined benefit pension plans. For this reason, conversions to cash balance pension plans can have a dramatic impact on the retirement security of older employees.

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[11] ADEA § 4(i)(A), 29 U.S.C. § 623(i)(A), makes it unlawful for an employer: " . . . to establish or maintain an employee pension benefit plan which requires or permits (A) in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age . . . "

[12] Other district courts have analyzed the issue differently. The benefit accrued issue in the *Cooper* v. *IBM* district court decision has been appealed to the Seventh Circuit Court of Appeals.

APPENDIX B

LEGISLATION SHOULD PREVENT THE POST-CONVERSION WEAR-AWAY OF EARLY RETIREMENT BENEFITS

1. Early Retirement Wear-away Should Be Prevented By Use Of The Sum-Of Approach For Subsidized Early Retirement Benefits.

As noted, a wear-away period can occur if, as is often the case, the traditional defined benefit plan provided a subsidized early retirement benefit before the conversion. In such a case, a participant who qualifies for the early retirement subsidy (before or after the conversion) might experience a period of years after the conversion in which continued service for the plan sponsor generates no net increase in the early retirement benefit because the value of the new-formula benefit at early retirement age remains less than the value of the old-formula benefit at that age.

Any cash balance plan legislation should make clear that this type of wear-away period (an "early retirement benefit wear-away") as well as normal retirement benefit wear-away—is prohibited. Early retirement benefit wear-away can affect many participants in converted plans, including those who are subject to a wear-away of their normal retirement benefit. The harm to older workers and the age discrimination concerns raised by the normal retirement benefit wear-away also apply to the early retirement benefit wear-away. Moreover, an early retirement benefit wear-away can continue long past the time when a normal retirement benefit wear-away has ended.

The early retirement benefit wear-away can be prevented by grandfathering or by applying the "sum of" (or "A + B") approach described above to early retirement benefits. (This could be done in tandem with a similar approach to normal retirement benefits or an adequately protective "greater of" approach with an appropriate opening account balance for normal retirement benefits). As a result, a participant who retired while entitled to a subsidized early retirement benefit under the old formula would receive the sum of that subsidized early retirement benefit annuity and the excess of the cash balance account over its opening account balance (in other words, the subsidized early retirement annuity plus the increase in the cash balance account).

Consistent with the nature of subsidized early retirement benefits, this approach would be contingent. It would not apply unless the participant was entitled to a subsidized early retirement benefit under the terms of the old plan formula at the time the participant took his or her benefit under the converted plan (whether the participant first qualified for the subsidized early retirement benefit before or after the conversion).

The plan sponsor could offer the participant the choice of taking the increase in the account balance as a lump sum, as opposed to taking it in the form of an annuity that is added to the old-formula subsidized early retirement annuity.

2. Incorporating The Early Retirement Subsidy In The Opening Account Balance Would Be Inappropriate.

Incorporating the value of the early retirement subsidy in the opening account balance would violate the prohibition against age discrimination. If the opening account balance were allowed to incorporate the value of the early retirement subsidy from the old formula, older participants could be given smaller opening account balances—and also smaller lump sum distributions upon retirement—than otherwise identical younger participants who qualify for the early retirement subsidy. In addition, because the subsidized early retirement benefit is contingent, including the subsidy in the opening account balance of all participants could create substantial windfalls for those participants who ultimately do not qualify to receive the subsidy.

The CHAIRMAN. I want to thank all of you for your testimony and for providing it briefly for us. Your full testimony will be a part of the record.

I want to know some more about this wear-away. Mr. Sweetnam, could you explain the issue and how it is different in conversions to hybrid plans than changes made in traditional defined benefit plans?

Mr. SWEETNAM. What the wear-away is—and we call it a benefit plateau—is where you have a protected benefit. The law protects everything that you have accrued up until the time of a change. So where you have that protected benefit, you are always going to get that.

What happens sometimes when you start a new cash balance plan, is that you will have a benefit under the new cash balance plan that may be lower than the protected benefit. Now, there are a couple reasons why that benefit may be lower. One may be because of changes in interest rates because sometimes what you do when you start off a new cash balance plan is that you take your old benefit and convert it into a lump sum distribution and make that your opening account balance. Well, if the interest rates changes on the protected benefit, that will mean that there is a wear-away. Some people call that inadvertent wear-away.

Another thing that can happen is, is that if you have under your protected benefit, early retirement subsidies—and an early retirement subsidy is something where you are promising really an increase in benefits for those people that leave early. But that increase in benefit goes down over time as you get closer to normal retirement age. One of the things that can happen in wear-away is where you have set up your cash balance benefit without including early retirement subsidy, something that I would note that AARP thinks is age discriminatory if you put early retirement subsidies in that opening account balance.

So here if you leave early, you may have a period of time where that early retirement subsidy, you take that under your old benefit formula, your old protected benefit formula, and that might be greater than the other benefit formula.

There was a third type of wearaway which really is not used that much, and that was where people set up that opening account balance using a very different interest rate than the current interest rate used to pay out benefits. Since the current interest rate used to pay out benefits, which is based off of the 30-year Treasury rate, it is so slow many companies did not do that, and our testimony talks a little bit about that.

The CHAIRMAN. Could you also cover the whipsaw theory of liability a little bit so that we know how it affects the employer's behavior and the employee's benefits?

Mr. SWEETNAM. Whipsaw is when you decide how much the benefit has to be paid out when you convert a benefit stream into a lump sum distribution. The way that you—the law says that you must calculate a lump sum distribution—is you take the future payment stream and you discount it using the 30-year Treasury rate. So if you were going to take an immediate distribution from your cash balance plan, what you do is you take the interest rate that you are guaranteeing under your cash balance plan, use that interest rate to determine what the benefit would be at age 65, discount that back to current using the 30-year Treasury rate.

Well, if you use an interest rate that is different than the 30-year Treasury rate, what you are going to have is a benefit that is higher in doing this discounting than the benefit that you had actually promised people.

Now, unfortunately what this does is either one of two things. It forces employers to use as a crediting rate the 30-year Treasury rate, which makes employees a little bit mad because they know that the company is making more money in that pension plan than the 30-year Treasury rate. And then, No. 2, what it does is that if a company tries to do a good thing and do a better interest rate

crediting, what happens is that they have to pay even more money than was actually promised. Unfortunately, there have been three circuit court cases that have confirmed this whipsaw theory, and I believe that it is something that the Congress really has to address.

Mr. CERTNER. Mr. Chairman, I think this is a classic example of why the hybrid cash balance plan does not fit within the DB plan rules.

The CHAIRMAN. I got that from your testimony.

Mr. CERTNER. The whipsaw is exactly something——

The CHAIRMAN. I really need to ask Ms. Collier a question here. I am sure you will get some other opportunities to speak on it.

Ms. Collier, given what you know about the uncertainty of the law in the hybrid plans, what do you think Eaton would have done with its traditional plan, keep it or convert it to a 401(k) plan? If the law is not clarified soon would you unconvert the hybrid plan and return to traditional design?

Ms. COLLIER. I am dreading that possibility. I can honestly say that we would not entertain the notion of just completely reverting the employees who converted voluntarily via our choice program back to a traditional program. I have already seen from peer companies in my industry and elsewhere, with the uncertainty around cash balance plans, what employers by and large have already started to choose to do is to freeze the defined benefit plan and just put in 401(k) plans. I have served as a recommendation for different firms, and people come to me based on our experience, and they are not coming any more asking about switching to a cash balance plan. They are all abandoning the retirement program and just putting in the 401(k) plan.

The CHAIRMAN. Thank you. My time has expired.

Senator Mikulski?

Senator MIKULSKI. I want to thank all members of the panel for their testimony.

Essentially my State represents kind of what is happening and why there would be a need for a hybrid plan. Most of the jobs in the Baltimore community, and even those who work for Government were defined benefit. We are transforming ourselves into an innovation economy. Research, technology, development, biotech, infotech, you name it, and younger workers are very different.

This then takes me—I could ask questions to all of you, but, Ms. Collier, I would like to stick with you because you actually went through this. No. 1, what do you think helped with the whole issue of morale and also to protect you from lawsuits around the so-called age discrimination? It is not so much age discrimination, it is the length of time, the length of work time issue. You could go to work, for example, in a defined benefit plan, particularly in manufacturing, at age 20 and 30 years later you are 50, so you would be eligible for that famous 30-years-and-out that so many workers did.

Ms. COLLIER. Right.

Senator MIKULSKI. Could you tell me, No. 1, you had good information. What all did you do that managed the morale issue and the information issue, and would that be lessons learned? And

would you recommend that that type of information requirement be mandated?

Ms. COLLIER. Well, actually we did follow, Senator Mikulski, some requirements that came out. When we were designing our program, wear-away was a big issue and disclosure was a big issue, and Congress passed a law in 2001 enhancing the disclosure requirements. And we feel like we equaled or exceeded those.

We also learned from past practices of other employers and we built upon those, and I think that is a common thread throughout industry. We had a very, very detailed communication campaign. We had over 250 meetings at our 100 sites throughout the country, Web sites.

Senator MIKULSKI. So you went over and beyond the Federal requirement which is why people——

Ms. COLLIER. Yes, we did. We went over and beyond the Federal requirement, but I think a lot of employers do voluntarily. There is about 90 percent in a survey from Watson Wyatt last year that would indicate that about the high 80s or low 90s of employers do provide transition benefits.

Senator MIKULSKI [CONTINUING]. Did that manage the morale and deal with the fear issue?

Ms. COLLIER. It did. We did not have one complaint on our cash balance conversion, and in fact, I think people were very grateful for the opportunity. We had a lot of confusion within Eaton. We used to be strictly in the automotive and truck industry and we are in five businesses.

Senator MIKULSKI. I understand. Let us go to the so-called length of time possible discrimination issue, and then the concern over real lawsuits, the copycats, etc. That is why people are bailing out of hybrid and going to 401(k) because they do not have to deal with it. Is that right?

Ms. COLLIER. Yes. And I think——

Senator MIKULSKI. But here is my question, which is how did you deal with it? What did you do to be able to deal with these two different types of pensions now, and how did you deal with the older employees?

Ms. COLLIER [CONTINUING]. The older employees, we did not want to preclude them, because our transition methodology was choice. And I have been involved in others where it was transition credits or grandfathering or a variety of techniques. But because ours was choice we did not want to preclude the older employees from choosing into the cash balance plan.

Senator MIKULSKI. Well, walk me through the case study. Could your workers actually—they could choose to stay with the——

Ms. COLLIER. Stay in their plan, and we had 5 or 6 different plans that they were already in, or they could choose into. It was a one-time option to choose into the cash balance.

Senator MIKULSKI [CONTINUING]. Let me ask it in my own way.

Ms. COLLIER. OK.

Senator MIKULSKI. For those who had been 20 years, they could choose to stay in the defined benefit or whatever was the version of those 5 plans, or they could transfer into the new plan.

Ms. COLLIER. Yes.

Senator MIKULSKI. And that was up to them. But once you made your choice, that was it. You could not say, whoops or——

Ms. COLLIER. No. But in order to prevent the whoops we had individualized packages, we had Web sites that you could model your own interest rates. We fully disclose the wear-away and the impact of it in meetings and individually on people's statements and hypothetically.

Senator MIKULSKI [CONTINUING]. How did you deal with the issues on which lawsuits are usually done? Was it because you offered choice, or how did you deal with it economically?

Ms. COLLIER. Well, the lawsuits at the time we were looking at the plan actually were coming down in favor of the plans not being age discriminatory, but obviously we looked at those, and we felt that choice and heavy disclosure would prevent us from being exposed to lawsuits.

Senator MIKULSKI. And has your legal counsel advised you that then under current law that would be compliant, or are you scared that in the absence of better legal clarification and some of the recommendations that we would hope to build on a consensus.

Ms. COLLIER. We are very concerned about absent legal requirements and legal clarification.

Senator MIKULSKI. So in other words, we could end up penalizing the good guys.

Ms. COLLIER. Absolutely.

Senator MIKULSKI. Which is the 401(k). You are kind of on your own. In some companies it is almost Darwinian, but here you are trying to have the benefits of protecting one school of thought or approach to work, and then as well as the new workers who will be portable?

Ms. COLLIER. Yes.

Senator MIKULSKI. Yet you feel that because the hybrid plan, even though they say they might move in 4 or 5 years, there would be now a stake in them staying because you have a good pension.

Ms. COLLIER. Right.

Senator MIKULSKI. And it is clear and in some ways you have the information about what to expect.

Ms. COLLIER. Yes.

Senator MIKULSKI. What you are worried about, that for these efforts to accommodate the new economy, you could be penalized because we have an outdated framework.

Ms. COLLIER. Absolutely, and we were making our decisions in good faith based on a lot of legislative guidance that was out there at the time, and we had actually received a termination letter on our plan. We received that prior to the choice process. So we had a lot of guidance that would indicate we were within legal boundaries.

Senator MIKULSKI. Thank you.

And I appreciate—for the men there, it was excellent, but I am kind of a case study person and this was very helpful to me. Thank you.

The CHAIRMAN. Senator Isakson?

Senator ISAKSON. If I can, I want to follow up with Ms. Collier for a second. Evidently Eaton had made a number of acquisitions, so how many different defined benefit plans did Eaton have?

Ms. COLLIER. That were involved in the conversion, we had 6, and then we have about 15 represented plans including two multiemployer plans.

Senator ISAKSON. When you made this acquisition of the company that had 5,000 employees who had no plan, that was kind of the trigger to say, hey, we need to take a look at what we are going to do—we are a growing company—for the future. And that is when you created the choice and the cash balance option. So the other 5 plans, people had the choice, if they were vested in any of those 5 plans, to stay in that plan——

Ms. COLLIER. Actually, even if they were not vested.

Senator ISAKSON [CONTINUING]. Even if they were not vested they had the choice of staying in that plan or opting out cash balance; is that correct?

Ms. COLLIER. Correct.

Senator ISAKSON. Mr. Certner, I want to ask you a question, and I want to try and frame this in the right way because I think it gets to the heart of this issue. Eaton was a growing concern from a relatively small business to what anybody would consider to be a significant national company, large number of employees, multiple State, etc, and in those acquisitions and in the different plans it finally found itself in a position where it wanted to centralize its benefit plan, create a mechanism where it was as fair and uniform as possible for both new acquirees as well as older people.

In your statements about the issue on age discrimination and defined benefit plans you kept referring to expectations of employees. Now here is my question. It sounds to me like Mrs. Collier's company, Eaton, by offering choice, allowed anybody who had earned any level of defined benefit to have the choice to keep it or have the choice to go out, but did not allow anybody to be guaranteed expectations if they had done other things. I guess what I am saying is on this whole age discrimination issue and on the whole issue of benefits, it seems like we have to deal with what people should expect, reasonably expect, and what companies should be able to expect to be able to deal with changing times. I would like for you to address that for a second.

Mr. CERTNER. If I understand what Eaton has done, which is basically to give all of the employees choice of which plan to go into, we have no problem as a matter of policy with that kind of decision. We think a cash balance plan is a legitimate plan design that a company may wish to choose as a matter of policy, and as long as the older workers are protected—I think they even went beyond that by providing it to all workers—then we do not have any problem with that as a matter of policy.

Of course what I have said earlier, and I think what the courts have said, is that, regardless of what we may think is a good policy, that we are still dealing with the law today and we think the law basically is saying that these hybrid cash balance plans do not exist under the framework that we currently have today, but as a matter of policy we think it is appropriate to change that framework to make sure that we can do plans like cash balance plans in the future, so long as we are doing what we did in our company, which is to protect the old workers, to let them stay in the old plan if they wanted to. That way you can adapt your plans to changing

times while still protecting the people who have already put a lot of years into a plan where really in the traditional plan context, you do not earn a whole lot in those early years in the plan, and so if they are protecting them by keeping them in the plan, we have no problem with the policy that has been accomplished by her company.

Senator ISAKSON. It seems to me, continuing on that theme for a second, it seems to me that we are at a point of where we are going to go one direction or another. We do not have the luxury of much time. We have to deal with the *Cooper* v. *IBM* case. We have to deal with that one way or another. Second, we have to deal with the reality of what is happening in the workplace, and I am dealing with it in terms of aviation pensions right now.

It seems like to me that if we can provide companies with the ability to preserve benefits to the maximum extent possible and make conversions for the future so there is an option for defined benefits, we are far better off than if we take a position that because current law says X based on interpretation, we are going to force all plans to go into just 401(k) type plans. If we take your testimony out to the Nth degree in terms of what we did here in Congress, would we not more or less, based on what Mr. Sweetnam and Ms. Collier said, be in a position where everything is going to be just defined contribution plan and there will be no defined benefit plans?

Mr. CERTNER. Yes, and we do not think that would be a good approach, and so the cash balance concept is not a bad idea as a matter of policy. It does have a number of benefits we think for employers. As long as we deal with the transition issue for employees who are currently under the traditional plan we think we can make this work, and we think we can create a good statutory framework and amend the law to make sure that cash balance plans are legal, are not subject to challenge at the same time that we protect the older workers' benefits.

Senator ISAKSON. I see my time is up. I will yield back.

The CHAIRMAN. Senator Kennedy?

Senator KENNEDY. Thank you, Mr. Chairman. I want to thank our Senators Mikulski and DeWine for helping so much in chairing this hearing this morning, and I thank you as well for the focus and attention you have given this issue previously. Our general roundtable was enormously helpful and valuable, and your working with the Finance Committee, all of us hope that we can work together. We do have some shared responsibility, and I thank all of those who have worked to bring us to this point. We have some important meetings that are coming down the road next week, next Thursday I believe.

I think all of us were struck this morning when we saw in the Post and the major report in the New York Times as well about the pension plans falling further behind this whole reporting process. I was here at the time when we passed that ERISA in 1974 I believe. I think we are going to get a lot of questions about that reporting. We are not getting into that, as I understand, today, but this is just one additional feature of a very complex but enormously important kind of issue in terms of retirement security that I think is increasingly of concern to workers as they have listened to the

debate and discussion on Social Security, as they see a lot of their savings gradually disappear, the costs going up in so many different areas, and these pensions so at risk.

I think what we have seen is what has happened with the single pension program, and I think we heard earlier—I will look forward to read through the testimony—about the importance of taking action now with the multi-employer. We have an opportunity to take action now, and with the combined sort of recommendation of business and labor to make some very important progress. I think the points that are being made here again this morning by our panel are excellent and very, very important to us.

But generally, when people start talking about pensions their eyes glaze over when the words just come out of your mouth, but I think what we are finding out in real terms, this is at the heart and the soul about security for millions of Americans, and we have to address it.

I welcome Senator Isakson mentioning about the airlines, because we are not going to look at dealing with these kinds of issues. We are just going to be so far behind the ball. And I am troubled that we have not gotten some recommendations from the administration to deal with this issue here.

I do not know, just in the time I have left, Mr. Certner, whether you have reacted or responded to the administration's general proposal. Have you commented on that earlier? I apologize if you have. I do not want you—I will take the opportunity to read on through it, but if you might want to just use the few minutes I have left to just sort of elaborate on it.

Mr. CERTNER. I think you are referring to the funding proposal from the administration. I think we are facing a very difficult time in the pension funding world because we are coming out of a time period where we have had some downturn in the market, we have lower interest rates which means liabilities are going to be projected to be larger, and we have had a little bit of a slower time in the economy, and so many companies right now are finding it very difficult to make up some of the funding shortfall that they have seen. I think some of the numbers you probably see in that report is suggesting that funding shortfall has really grown pretty substantially because we have had this kind of perfect storm of events I think that are affecting companies dramatically.

But in part, the PBGC is really designed to fill in the gaps when these kinds of times occur. If companies did not go under and lose some of the benefits for individuals, we would not need a PBGC in the first place. So the fact that the PBGC would have to step in now and then I think is anticipated. The fact that we are going to have some bad times when there is going to be more stress on the PBGC I think is going to be anticipated, and I think as we move forward and try to correct some of the funding inadequacies, we really do have to make sure we meet that proper balance of ensuring that plans are properly funded to pay their future benefits, but not overly burdened so that they will want to get out of the system. I think that is the kind of balance that we are all struggling with right now.

Senator KENNEDY. Do you favor a moratorium now, ending pensions over a period of time till we have an opportunity to address

these issues in the Congress? Should we give some thought to that as well?

Mr. CERTNER. Well, I do not know that we need to act precipitously about matters for the PBGC. It is not an immediate cash flow crisis. They can certainly continue to pay benefits for years and years.

Senator KENNEDY. What, have they gone from, what 23 billion surplus to what is it now? What are the figures now?

Mr. CERTNER. They are in the red now. I am not sure what the latest numbers in this report are. I mean I think that is what you saw happen when the stock market burst, when interest rates went down with the slower economy, you suddenly saw a dramatic turnaround. A dramatic turnaround in the whole economy affects the PBGC just as much as it affects the rest of the economy, and PBGC is really seeing and experiencing the negative effects of that economy now.

Senator KENNEDY. As I understand, it is 23 billion in deficit now at the present time. Have this panel or earlier panels commented upon these retirement programs, the fairness issues that have been raised? Have you talked about that at all today? I do not know whether any of you have. I can see the blinking red light here. Any of you have any particular, comments about this previously, written about it, thought about it, or have some recommendations on some of those issues which are the basic equity issues where the workers got short shrift and there is substantial benefit that goes to the CEOs?

Do not all jump in on that at one time.

[Laughter.]

Mr. CERTNER. Senator, one of the problems that employees certainly are facing is that they obviously are not the ones that caused the pension underfunding problem. They are now perhaps close to retirement. They are looking and depending on these pension plans. Many of them may be seeing dramatic reductions in their expected pensions. There are some proposals out there to further reduce, for example, the amounts that individuals can take out of the plans, and I think we have to be very cautious about what we are doing particularly to individuals who are at or near retirement and changing their benefit expectations, when they in essence had no control, no responsibility over the funding of these plans.

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

The CHAIRMAN. Thank you.

Senator Harkin?

Senator HARKIN. Thank you very much, Mr. Chairman, and thank you for holding this hearing, Mr. Chairman. The issue of cash balance pensions, especially conversions, is one I have been involved in for a long, long time, and last year I called together a number of people in this room to start meeting on this and to try to work out a broad consensus to get over this hump on this thing. I know my staff has had many more meetings with some of the people here today.

I think both employee and employer groups seem to be asking for some kind of retroactive guidance. We need a clearer picture of

rights and responsibilities, and we need to find some common ground on which to proceed.

I have never been one opposed to cash balance plans. I want to make that clear. Under the new kinds of work that people are doing, and people do not sometimes stay with a company for 40 years like they used to. I mean people shift jobs a lot in our society today, and cash balance plans answer that kind of a need.

The real rub comes though is when you convert, and the terrible thing that has happened to so many people by companies converting from a defined benefit plan to a cash balance plan. I happen to agree with whoever said that they are not—these really are not defined benefit plans, by the way, and what happens with wear-away.

Again, I remind people here that I had an amendment, a sense of the Senate resolution I offered in the Senate in 2000. It was approved overwhelmingly by the Senate, that wear-away should not be permitted, should not be permitted. That was in 2000. So we have got to find a way that we can, if the companies want to make the conversions, it is done fairly, but that protects the accrued benefits of the older workers.

I think the Treasury Department, I think, is a pretty good starting point. I want to particularly thank Secretary Snow—I will say that publicly—for the approach set forth in their proposal. It is a vast improvement over the proposed regulation of December 2002. Senator Durbin and I met with Secretary Snow in January of 2003 just prior to his confirmation vote, and he said he had worked for fair transition rules. We talked about the rules that they had had at the CSX Railroad from which he had come. So I believe that Treasury's legislative proposal is a good starting point. So again, the issue here of trying to protect older workers.

Now, Mr. Certner, before I left to take a phone call you were about to respond to an issue of wear-away that Mr. Sweetnam was talking about, and I wanted to ask you to finish your thought on that because I want to say something about it too, but I wanted you to finish your comment on the wear-away situation.

Mr. CERTNER. Thank you, Senator. I do want to thank you for your leadership on this issue because I think some of the actions you have taken earlier on has enabled Treasury to put out a better more constructive proposal that we can work from.

Wear-away is based on many factors, how many years you have worked, what the plan design is, but always age is a factor in determining the length of the wear-away. And the law is very clear that you cannot stop or reduce pension accruals based on someone's age, and in a wear-away situation, clearly the older you are, the longer your wear-away period. We have seen wear-away periods, and these are periods in essence where you are running in place, you are not earning any additional pension in the plan because your benefit in the new plan still has not caught up to what you would have gotten in the old plan. We have seen wear-away periods that can be 15 years. These are clearly violative of the letter and spirit of the law, and we believe that they are illegal currently today. We are glad that treasury has formally said we should ban all forms of wear-away. We are glad that most companies now have moved away from having a wear-away situation. You do not need

a wear-away when you do a conversion to a cash balance plan. But we think they are illegal today and we would welcome the law clarifying that.

Senator HARKIN. How do you feel—I will ask all three of you, starting with Mr. Sweetnam—how do you feel about the opportunity for older, longer-serving workers to choose between an old and a new plan, and what would you think about what would the period of grandfathering be that you might come up with, Mr. Sweetnam?

Mr. SWEETNAM. Well, the American Benefits Council is very concerned about having that sort of a grandfathering provision. Plans are voluntary, and we do not want to have a one-size-fits-all solution. By having some sort of a mandatory grandfather, what that is saying is that you cannot change your plan, you as an employer cannot change your plan with regard to those employees. Now, that is very different than being able to change your plans in order to react to changes in the workplace and to moving into this.

Now, we think that currently the marketplace has been working in a way that people are reflecting, companies are reflecting those sorts of concerns, but let the marketplace work and let it be not one-size-fits-all, but let everybody do what best suits their particular market.

Senator HARKIN. Are you opposed to letting a person, let us say an older worker who is aged 45 or 50, who has participated in a plan for 20 years, and the company wants to put in a cash balance plan. Are you opposed to having that person choose between keeping the defined benefit plan or having to go on the cash balance plan?

Mr. SWEETNAM. I am not opposed—the Council is not opposed to allowing that to happen. We are opposed to mandating that happening. For example, what if you were in a situation where——

Senator HARKIN. So then you are saying that a company can come in, go to cash balance and force a wear-away, you are all for that?

Mr. SWEETNAM [CONTINUING]. Senator, wear-away is actually a concept that has been used in various other situations with regard to changes in law that have come out of congressional mandates. For example, caps on the amount of compensation that you can have. When that cap was put in, Congress allowed and the IRS mandated that one way that you could reflect this was to do wear-away, wear-away those higher benefits. And so wear-away is a concept that is littered throughout employee benefits.

Senator HARKIN. And congress has said, we do not want that to happen in cash balance conversions because it is unfair.

Mr. CERTNER. The Treasury has proposed doing away with wear-away.

Senator HARKIN. I know that. In fact the regulation you worked on when you were at IRS, Mr. Sweetnam, has been done away with, and treasury has done away with that. Mr. Certner is absolutely right on that. Treasury has moved beyond that, and that is why I thanked Treasury because I think now we are getting to better ground rules here, where older workers can have some choice. I am not fixed on any period of years. Treasury says 5. I think that may be a little bit longer. I do not know what the proper thing is

there. But we have legislation some of us introduced that said anyone over 40 with 10 years or more of service ought to get to choose. Let them choose which one they want.

Ms. COLLIER. Senator, my concern would be the law of unintended consequences with that, because even the threat of mandates I believe is already starting to drive employers from the defined benefits system, and right now I have peer companies in my competitor group that have completely stopped their defined benefit system and gone to straight 401(k) without any such transition requirements.

Senator HARKIN. The only mandate that we are giving is the mandate that they be allowed to choose. We are not saying which one they have to choose, but they should be allowed to choose.

Mr. SWEETNAM. But, Senator, what that does is it says that really what you are saying is that you should either do this one-size-fits-all or terminate your plan——

Senator HARKIN. No.

Mr. SWEETNAM [CONTINUING]. —because you are not giving——

Senator HARKIN. What I am saying is that if you want to go to a cash balance plan, that is fine, but that the older workers who have been in a defined benefit plan for a long time, ought to be able to choose, should I stick with the plan that I have had or go with the other one. Now, I would remind you that Secretary Snow and the CSX Railroad, that is what they did, and it worked out just fine, and other companies are doing that.

Mr. SWEETNAM [CONTINUING]. What the American Benefits Council says is that we want people to have the opportunity to design their plans and their conversions whichever way they want. If what you are saying is that the employer does not have the ability to change its plan unless they do a grandfather, so the choices to the employer are one of three under that. One, maintain the plan which does not meet the current needs; two, maintain the plan for a period of years, which is whatever under your legislation is 10 years; or 3, terminate the plan and go to a 401(k). We do not think that those should be the options. We think that we should have much more flexibility and that the employer community has been able to deal with this in the marketplace to reflect their own needs, and we think that is the way that it should be.

Senator HARKIN. Maybe we are just talking past each other, but your second point that you pointed out there, I would define it differently than that. I would say that the employer could switch a plan, go to a cash balance plan. But for those older workers who could choose if they had over 10 years of service and they were over 40 years of age, then the employer would have two plans. They would have a plan that would be phased out over time that would be for the older workers that wanted to stay in defined benefit. Then they could have the cash balance plans for the younger workers.

Mr. SWEETNAM. But what that is doing is it is not giving the employer the ability to make the change. It is putting that decision someplace else. And what we say is having that sort of a requirement will result in more companies deciding to get out of the defined benefit system, because then they can make that change. Because you are not saying that—in this legislation you are not say-

ing that I cannot terminate the plan. You are just saying that if you want to move to one particular type of plan, that you have to give choice there. But if you wanted to terminate the plan, you have no choice, employee, you have no choice.

Senator HARKIN. Under the law right now you can terminate a plan.

Mr. SWEETNAM. That is true.

Senator HARKIN. Anybody can terminate a plan. Why do they not? Because workers will leave and go to another place to work.

Mr. SWEETNAM. Senator, I think there is a reason why it makes sense in a conversion from a traditional plan to a cash balance plan to give that choice that you do not do in other circumstances, and that is because under traditional defined benefit plans the way it works is when you are younger you have a small accrual and when you are older you have a larger accrual.

Senator HARKIN. That is right.

Mr. SWEETNAM. But in a cash balance plan it is exactly the reverse. When you are younger you basically accrue much larger benefits over time. When you are older you do not accrue as much. So when you convert from one to the other, you flip the plan design around completely, and that is why when you do that kind of a change it is completely appropriate to have some kind of grandfathering or choice as they realize they need to do in Eaton to be fair, and it is not the same as in other circumstances where you may want to make a design change in the plan or reduce the formula.

Here you are completely flipping the formula on its head, and it is so appropriate in that circumstance to have an appropriate transition for the older worker. Otherwise they lose. They get the worse parts of both plans and they can never catch up. They will be way behind. And we have heard this from thousands of our members. This is a very complicated issue, but this is not an issue that we brought out to our members.

This is an issue that we heard about from all the individuals and all the companies that were affected by this, and you do not normally get this kind of self-created outrage in pension plans unless people really feel wronged here, and it is not as if these companies in many cases were on hard times and going out of business, did not have the money. These were companies that had very often surpluses in their plans that were readjusting their benefits but they were creating winners and losers in their plan and the losers were always the longer service older workers, and that is why providing some kind of a grandfathering choice or other kind of transition protection makes sense in the cash balance context.

You are not mandating that the employer do anything. You are just saying that if you choose to go this route—and you have many routes you can go—but if you choose to go the route of changing to a cash balance plan, here is a set of rules that you need to follow.

The CHAIRMAN. I want to thank everybody for participating in this. We have a vote that is already at the halfway point. The time has been greatly extended already, and you may submit any questions you want to either panel, and I would hope that you would all respond timely and with the same enthusiasm and ability that

you have already demonstrated. I have a whole bunch of questions that I would also like to ask of each of you.

And one of the things that kind of ties both the panels together I think is that I think the hybrid plans are actually asking for less than the multi-employer plans, but both need solutions and we need to work on both of them.

so with that, I will adjourn this hearing and leave the record open so that we can submit additional questions.

Thank you all.

[Additional material follows.]

ADDITIONAL MATERIAL

PREPARED STATEMENT OF THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Health, Education, Labor and Pensions (HELP) Committee on reforming cash balance or similar hybrid defined benefit pension plans.

ASPPA is a national organization of approximately 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 commends the Senate HELP Committee for examining the issue of hybrid plans. These plans constitute vital and powerful tools for building a stronger and more effective national retirement system.

THE IMPORTANCE OF A DEFINED BENEFIT PLAN SYSTEM

The importance of promoting defined benefit plan coverage for our Nation's workers cannot be overstated. There are approximately 80 million working Americans who are not covered by a defined benefit plan. This represents 75 percent of our private workforce not covered by a plan that provides guaranteed benefits. The lack of defined benefit plan coverage is even more acute among small business workers. Less than 2 percent of the 40 million workers who are employed at firms with less than 100 employees are covered by a defined benefit plan.

The Americans not covered by a defined benefit plan will not have their benefits affected by a cash balance "conversion" since they are not currently covered in a defined benefit plan to begin with. They work at companies that you have never heard of, companies that do not have commercials on TV, but companies that will lead our economic recovery. Don't these workers at these companies deserve a chance at a more secure retirement?

Some of these workers, if they are fortunate enough, at least have been covered by a defined contribution plan, such as a 401(k) plan. However, 401(k) plan benefits, unlike defined benefit plans, are completely dependent on the amount contributed and are affected by investment income and expenses.

Due to recent declines in the stock market, millions of American workers relying solely on 401(k) plans have been forced to delay retirement or seriously reevaluate their retirement standard-of-living expectations. The effect is more than just not being able to buy that dream retirement home. It can be the difference between being able to afford adequate long-term care or needed, but expensive, prescription drugs. These unfortunate consequences would have been greatly diminished if these Americans had been covered by a defined benefit plan providing guaranteed retirement benefits not subject to the whims of investment markets.

Defined benefit pension plans provide a guaranteed monthly retirement benefit for employees. This annuity benefit continues for the life of the worker and cannot be exhausted. 401(k) plan benefits, on the other hand, are not guaranteed. Ultimately, the level of benefits from a 401(k) plan and the length of time they continue to be paid are unknown to the retiree. Without increased defined benefit plan coverage, as Americans live longer than ever before, there is a greater risk that many Americans will outlive their retirement savings.

Faced with defined contribution plan account losses, a cash balance plan funded with employer contributions and with a guaranteed rate of return is an attractive option in today's market. Any worker covered only by a defined contribution plan would welcome the prospect of coverage under an employer-funded cash balance plan that provides more certainty.

CASH BALANCE GUIDANCE NEEDED

For better or worse, the last and best hope for promoting new defined benefit plan coverage is cash balance or similar hybrid plans. The good news is that there are thousands of businesses throughout the country who, in light of current developments in the stock market, might be interested in adopting a defined benefit plan such as a cash balance plan for their workers. Such plans could potentially cover

millions of American workers. However, there are a number of significant legal uncertainties associated with cash balance plans because of the way benefits are accrued and distributed when compared to traditional defined benefit pension plans. Employers face uncertainty over how age discrimination rules apply to cash balance plans. Although these issues are technical in nature, they are critical to the legal operation of the plan.

Unlike their larger counterparts, small and mid-sized businesses cannot afford high-priced lawyers to provide legal opinions to help sort through the various unanswered questions. Until all of the important legal uncertainties surrounding cash balance plans are resolved in a clear and unambiguous way, small and mid-sized companies will refrain from offering these valuable defined benefits to employees.

Ironically, according to a survey published in PLANSPONSOR magazine, interest in defined benefit plan coverage among employees has increased by 20 percent as employees find it difficult to manage their 401(k) plan accounts. However, small and mid-sized businesses are no longer interested in traditional defined benefit plans because of their inherent funding uncertainties and because employees simply do not understand them. Cash balance plans can provide employers with more predictable funding requirements and, because of their "account-based" nature, they are often more appreciated by employees.

ASPPA is focused on employees currently without a defined benefit plan. Faced with consistent 401(k) plan account losses, a cash balance plan funded with employer contributions and with a guaranteed rate of return looks pretty good right now. Any worker covered only by a 401(k) plan would welcome the prospect of coverage under a cash balance plan funded by the employer and certainty respecting investments. In fact, putting aside the issue of "conversions," no rational or cogent policy argument can be made that workers without any preexisting defined benefit plan are also better off without a cash balance plan.

ASPPA understands, nevertheless, that there are important issues applicable to conversions that must be resolved. However, we believe that because of the important role cash balance or other hybrid plans will play in the creation of new defined benefit plans, Congress should separately address issues surrounding conversions from defined benefit to cash balance plans. The goal should be to provide the 80 million working Americans with no defined benefit plan the opportunity for a more secure retirement.

Given all of the competing interests striking the appropriate balance is not an easy task. We commend you for your efforts and urge you to stay the course.

SUMMARY

Any legislative or regulatory policy must keep in mind the vital role defined benefit plans play in providing working Americans with a more secure retirement. Account-based defined benefit plans, like cash balance plans, constitute vital and powerful tools for building a stronger and more effective private retirement system. ASPPA believes that legislation clarifying the legal status of cash balance or other hybrid plans will most certainly lead to a significant number of new plans, particularly among small and mid-sized employers, providing defined benefits to employees who have never before had such benefits. ASPPA urges Congress to enact hybrid legislation as rapidly as possible so that millions of working Americans at small and mid-sized companies nationwide have the opportunity to achieve a secure retirement future.

PREPARED STATEMENT OF UPS

UPS is pleased to submit this statement in support of the Multi-Employer Pension Plan Coalition's proposal. This legislation draws from the work product of a large coalition of employers, organized labor, pension plan trustees, actuaries and trade associations that have worked for months to develop proposed legislation that protects the long term benefits of workers participating in Multi-Employer Pension Plans (MEPP's).

UPS believes that this legislation is a balanced solution that meets the key criteria for addressing outdated pension rules: it effectively corrects the funding problems of MEPP's, it ensures that employers properly fund their pension promises on behalf of workers, and it protects taxpayers by setting up early warnings and safeguards.

As part of that broad-based Coalition, and on behalf of over 127,000 active UPS employees participating in these plans to help secure the legislation's enactment, UPS wants to be on record in support of the Proposal.

The key elements in the Multi-Employer Pension Plan title of the Proposal provide the following:

• Stricter Funding Requirements for Benefit Increases: Plans will be subject to stricter funding levels that limit the trustee's ability to increase benefits if the plan is not properly funded.

• Transparency and Employer Contributions: Trustees must notify all participants if their plan is significantly under funded and employers must increase their contributions to help improve the funding levels.

• Strong Reliance on Collective Bargaining: The contributions to the plan, and benefits received from the plan, will remain part of the collective bargaining process.

• New Powers for Managing the Plans: The plan's trustees will be granted the tools to balance plan assets and promised future benefit payouts. It is important to note that vested benefits are not required to be cut. However, a limited power to make necessary adjustments to those benefits will now rest with the union and employer designated trustees of a plan. That authority is but one of several tools which would be provided to trustees to avert greater risks to workers' pensions.

In many ways, the trustees of MEPP's are called upon to provide the same type of protections that are assigned to the Pension Benefit Guarantee Corporation (PBGC) for single-employer pension plans. This legislation now gives MEPP trustees the needed authority to address problems early-on. Such early responses will help avoid the need for later PBGC intervention and taxpayer-provided relief.

UPS commends its partners in the Coalition for their spirit of cooperation and compromise. The product of those efforts is a balanced and reasonable solution for a serious problem. UPS will continue to work with the Coalition to ensure enactment of the Proposal this year.

For further information regarding UPS's position on this legislation, please contact Marcel Dubois at 202-675-3345.

[Whereupon, at 12:09 p.m., the subcommittee was adjourned.]

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