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RETIREMENT SECURITY AND DEFINED BENEFIT PENSION PLANS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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RETIREMENT SECURITY AND DEFINED BENEFIT PENSION PLANS

THURSDAY, JUNE 20, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room 1100 Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory and revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
June 11, 2002
No. OV–14

Contact: (202) 225–7601

Houghton Announces Hearing on Retirement Security and Defined Benefit Pension Plans

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to explore retirement security issues relating to defined benefit (DB) pension plans. **The hearing will take place on Tuesday, June 18, 2002, in the main Committee hearing room, 1100 Longworth House Office building, beginning at 11:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include a representative from the Pension Benefit Guarantee Corporation and other defined benefit pension experts. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

This hearing will examine issues related to and recommendations for improving DB pension plans. This will be the third hearing the Committee on Ways and Means will hold this year on retirement security. On February 26, 2002, the full Committee held a hearing on retirement security and defined contribution plans, and on March 5, 2002, the Oversight Subcommittee held a hearing on employee and employer views on retirement security, focusing on defined contribution plans.

In announcing the hearing Chairman Houghton stated, "In our continuing review of employee retirement security, the Oversight Subcommittee will hear about the strengths and weaknesses of defined benefit pension plans. Recently, there has been an increase in the number of employers offering defined contribution plans. It is important for Congress to learn why employers have shifted away from defined benefit pension plans and the effect of this shift on retirement security."

FOCUS OF THE HEARING:

The hearing will focus on retirement security issues specifically related to DB pension plans. Specifically, the hearing will examine the role of DB pension plans in retirement security, rules and regulations governing DB pension plans, the advantages and disadvantages of offering and participating in such plans, and recommendations for improving DB plan participation.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by the close of business, Tuesday, July 2, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Oversight in room 1136 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

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

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

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

*** NOTICE—CHANGE IN DATE AND TIME ***

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
June 14, 2002
No. OV–14–Revised

Contact: (202) 225–7601

Change in Date and Time for Subcommittee Hearing Retirement Security and Defined Benefit Pension Plans

Congressman Amo Houghton, (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee hearing on retirement security and defined benefit pension plans, previously scheduled for Tuesday, June 18, 2002, at 11:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will be held instead on Thursday, June 20, 2002, at 2:00 p.m.**

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by the close of business, Friday, July 5, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Oversight in room 1136 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

All other details for the hearing remain the same. (See Subcommittee Advisory No. OV–14 dated June 11, 2002.)

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

Chairman HOUGHTON. Good afternoon, ladies and gentlemen. The Committee proceedings will start now. I will make a few comments and my associate, Mr. Coyne will, and then we will turn this over to you, Mr. Gutknecht.

To put a little background on this, in March the Subcommittee on Oversight held a hearing on defined contribution pension plans (DC plan). At this hearing, we heard from small and large businesses, the American Federation of Labor-Congress of Industrial Organizations, and also pension experts. They discussed the opportunities, problem areas, and suggestions for improvement of defined contribution plans.

Now, 9 days after his hearing, this Committee took action and passed some of the recommendations discussed at the hearing as part of the "Employee Retirement Savings Bill of Rights." These provisions went on to be passed by the House in April, and it was a great culmination of effort led by my good friends, Mr. Portman and Mr. Johnson, who serve on this Subcommittee, and Mr. Cardin. We thank all of them for their leadership and now, of course, await Senate action.

Today, what we want to do is continue this retirement security discussion by reviewing another type of retirement savings vehicle—defined benefit pension plans (DB plan). While defined contribution plans have increased in recent years, the number of defined benefit plans continues to fall.

So, the question is, what is causing it? We will hear from the insurer of these plans, the Pension Benefit Guaranty Corporation (PBGC), and they will tell us a little bit about the trend. We also will hear from pension experts on the positive, and also the negative aspects of defined benefit pension plans, as well as their risks and suggestions for improvement.

First of all we are going to hear from Congressman Gil Gutknecht of Minnesota. Mr. Gutknecht will talk to us from personal knowledge of an experience in his district and about the impact on workers when the employer converts a traditional defined benefit

pension plans into a hybrid defined benefit plan called a cash-balance plan.

A retirement plan is an essential employee benefit. Yet, companies are not required to offer, as you know, retirement plans and can modify, convert, or eliminate these at their will.

So, what is the right balance and what can be done to encourage pension plan participation and also better the future of our retirement security? As with our pension hearing in March, I hope that this discussion will yield some fruitful results.

I am pleased to yield to my colleague, Mr. Coyne.

[The opening statement of Chairman Houghton follows:]

Opening Statement of the Hon. Amo Houghton, Chairman, and a Representative in Congress from the State of New York

Good morning. In March, the Oversight Subcommittee held a hearing on defined contribution pension plans. At this hearing, we heard from small and large businesses and their employees, the AFL–CIO, and pension experts. They discussed the opportunities, problem areas, and suggestions for improvement of defined contribution plans.

Nine days after this hearing, this Committee took action and passed some of the recommendations discussed at the hearing as part of the "*Employee Retirement Savings Bill of Rights*." These provisions went on to be passed by the House in April. It was a great culmination of effort led by my good friends Mr. Portman and Mr. Johnson—who both serve on this Subcommittee—and Mr. Cardin. We thank all of them for their leadership and now await Senate action.

Today, we want to continue this retirement security discussion by reviewing another type of retirement savings vehicle—defined benefit pension plans. While defined contribution plans have increased in recent years, the number of defined benefit plans continues to fall. What is causing this decline? We will hear from the insurer of these plans, the Pension Benefit Guarantee Corporation, about this trend. We also will hear from pension experts on the positive and negative aspects of defined benefit pension plans, as well as their risks, and suggestions for improvement.

But first, we will hear from Congressman Gil Gutknecht of Minnesota. Mr. Gutknecht will talk to us—from personal knowledge of an experience in his district—about some of the ramifications on workers when an employer converts a traditional defined benefit pension plan into a hybrid defined benefit plan called a cash-balance plan.

A retirement plan is an essential employee benefit. Yet, companies are not required to offer retirement plans and can modify, convert, or eliminate their retirement plans. What is the right balance and what can be done to encourage pension plan participation and better the future of our retirement security? As with our pension hearing in March, I hope that this discussion will yield some fruitful results.

Mr. COYNE. Thank you, Mr. Chairman. I want to thank Chairman Houghton for scheduling today's hearing on issues related to defined benefit plans issues.

Retirement security in America is one of the most important issues under the Committee's jurisdiction. This issue has become more important as we confront the problem of an aging population.

Americans are living longer than ever before. As more people live into old age with longer life expectancies, the adequacy of the financial resources available to them during their retirement becomes a very crucial issue. Defined benefit pension plans provide workers with a specific pension benefit upon retirement. This benefit is guaranteed by the Pension Benefit Guaranty Corporation.

Today more than 44 million workers participate in a defined benefit pension plan and rely on this important source of income during their retirement. Unfortunately, the number of defined benefit

plans has decreased in recent years, particularly plans having less than 100 participants.

This downward trend in defined benefit plans puts the retirement security of American workers at risk. This risk has been widely recognized in the pension community. A working group organized by the Pension and Welfare Benefits Administration (PWBA) recommended that the Secretary of the U.S. Department of Labor support legislation and regulatory changes as well that will restore the viability of defined benefit plans.

On March 5, 2002, when the Subcommittee on Oversight held its hearing, as the Chairman referred to on defined contribution plans, we agreed that there should be a similar hearing on defined benefit plans. Thus, it is appropriate that the Subcommittee, through this hearing, review, number one, the role of defined benefit pension plans in providing retirement security for all American workers.

The advantages to employers of offering defined benefit plans, and the advantages to the workers who receive benefits under this type of plan.

The role of the Pension Benefit Guaranty Corporation in achieving retirement security for all our workers, and the financial status of the Agency, including the impact of pending cases.

As well, any recommendations the pension experts can share with us on how to improve the viability of defined benefit pension plans.

I would like to personally welcome Karen Friedman of the Pension Rights Center to today's hearing. The Pension Rights Center, along the Women's Institute for a Secure Retirement (WISER) were very helpful to me in preparing H.R. 3488, the Retirement Opportunity Expansion Act of 2001.

At this point, Mr. Chairman, I would ask unanimous consent to include a written statement from Cindy Housell, Executive Director of WISER, in the record.

Also, I would like to thank all other pension experts appearing with us as witnesses today for their participation. I look forward to their testimony. Thank you.

[The opening statement of Mr. Coyne follows:]

Opening Statement of the Hon. William J. Coyne, a Representative in Congress from the State of Pennsylvania

I want to thank Subcommittee Chairman Houghton for scheduling today's hearing on issues related to defined-benefit plan issues. Retirement security in America is one of the most important issues under the Ways and Means Committee's jurisdiction. This issue has become more important as we prepare for our aging workers.

Americans are living longer than ever before. The average life expectancy of Americans born in 2000 has been estimated to be 76.4 years, compared to 69.7 for those born in 1960. As more people live into old age with a longer life expectancy, the adequacy of financial resources available to them during their retirement becomes a crucial issue.

Retirement savings, including savings under employer-sponsored pension plans, will be stretched over longer retirement periods. Thus, every step must be taken to ensure that all workers have a secure retirement. Defined benefit plans should play a major role is accomplishing this goal.

Defined-benefit pension plans provide workers with a specific pension benefit upon retirement. This benefit is guaranteed by the Pension Benefit Guarantee Corporation (PBGC). Today, more than 44 million workers participate in defined-benefit pension plans and rely on this important source of income during their retirement. Unfortunately, the number of defined-benefit plans has decreased in recent years, particularly with plans having less than 100 participants.

According to the Pension and Welfare Benefits Administration (PWBA) of the U.S. Department of Labor, the number of defined benefit plans declined from 175,000 to 59,500 between 1983 and 1997. Although the greatest drop in the number of plans was among plans with fewer than 100 participants, the decline in the greatest number of plan participants was among larger plans.

This downward trend in defined benefit plans puts the retirement security of American workers at risk. This risk has been widely recognized in the pension community. A working group organized by the PWBA recommended that the Secretary of Labor support legislative and regulatory changes that will restore the viability of defined benefit plans.

On March 5, 2002, when the Oversight Subcommittee held its hearing on defined-contribution pension plans, we agreed that there should be a similar hearing on defined-benefit plans. Thus, it is appropriate that the Oversight Subcommittee, through this hearing, review:

- the role of defined-benefit pension plans in providing retirement security for all workers;
- the advantages to employers of offering defined-benefit plans, and the advantages to the workers who receive benefits under this type of plan
- the role of the PBGC in achieving retirement security for all workers, and the financial status of the agency (including the impact of pending cases); and
- any recommendations the pension experts can share with us on how to improve the viability of defined-benefit pension plans.

I would like to personally welcome Karen Friedman of the Pension Rights Center to today's hearing. The Pension Rights Center, along with The Women's Institute For A Secure Retirement (WISER), were very helpful to me in preparing H.R. 3488, the Retirement Opportunity Expansion Act of 2001. If the Chairman is agreeable, I would like to include the written statement of Cindy Housell, Executive Director of WISER, into the hearing record.

Also, I would like to thank all the other pension experts for appearing as witnesses at today's hearing. I look forward to their testimony.

Thank you.

Chairman HOUGHTON. Thanks very much. Without objection, that will be so ordered.

[The statement of Ms. Housell follows:]

Statement of Cindy Housell, Women's Institute for a Secure Retirement

On behalf of the Women's Institute for a Secure Retirement (WISER) we appreciate the opportunity to submit comments to the members of the Committee on Ways and Means' Subcommittee on Oversight, on the Hearing on Retirement Security and Defined Benefit Pension Plans.

WISER is a nonprofit organization, launched in 1996 by the Teresa & H. John Heinz III Foundation. WISER's primary mission is education—providing women with information and retirement planning skills so that they can surmount the overwhelming challenges to securing retirement income. Our goals include increasing awareness among the general public, policymakers, and the business community of the structural barriers that prevent women's adequate participation in the nation's retirement systems.

Attached is an executive summary of our new report, *Your Future Paycheck, What Women Need to Know About Pay, Social Security, Pensions, Savings and Investment.* This report looks at the particular conditions that have prevented women from planning a secure retirement. Drawing upon a variety of sources, *Your Future Paycheck* shows why older women today are almost twice as likely as men to be poor, and examines why this trend is likely to continue for younger women.

We applaud this committee for focusing on the status of our nation's pension system, and for allowing us to bring to your attention the ways in which the system's current inadequacies affect women.

Reasons Why Women Need More Retirement Income:

- Women live longer than men.
- Women earn less than men so their Social Security and pension benefits are smaller.
- Women are likely to be single—and not remarry. Non-married women are more likely to be poor.

- Women are more likely to need long-term institutional care.

Retirement Challenges for Women Workers:

- Two out of three working women earn less than $30,000 per year.
- Half of all women work in traditionally female, relatively low paid jobs—without pensions.
- Women are more likely to work in part-time and minimum wage jobs without pensions
- Women's earnings average $.73 for every $1 earned by men.
- Women retirees receive only half the average pension benefits that men receive.
- Women as the primary family caregiverss experience long-term financial consequences by losing out on opportunities for compounded interest on 401(k) matching contributions, as well as a reduction in savings and investments along with the loss of pay increases, promotions, and training opportunities.

Women as low-wage earners saving for retirement

Over the past two decades there's been a shifting of the burden of retirement from the employer to the employee—a trend that will almost certainly have a disproportionate effect on all low wage workers but particularly women for the following reasons.

First, it is important to realize that the majority of women today, are clustered in low and middle income households. The median income for all working women in 2000 was $20,311 and for full time women it was $27,355. (See attached income chart) The fact that women earn 73 cents for every dollar earned by men creates less of an opportunity for retirement savings and means that women's pension benefits will be lower than those of men. It also means they have substantially less income available to put in an IRA or a 401(k) savings plan.

Because two out of three working women earn less than $30,000 annually, even a disciplined saver will have trouble accumulating much in savings at that level. Second, studies have shown that women's savings priorities are often focused on their children's education and not on retirement. Third, with women moving in and out of the workforce and from one job to another more frequently than their male counterparts, the problems associated with lack of portability become particularly acute for them. And again, because of priorities such as their children's education and medical emergencies, women often opt to cash out their 401(k) accumulations when they leave a job rather than keep the funds for retirement.

Finally, given the fact that women generally have smaller amounts saved in their 401(k) accounts and have less to fall back on from other sources, it is not surprising that they are often more averse to riskier investments that may provide a higher yield. It is not simply a lack of financial sophistication, it is actually a pretty rational behavior. Consider the startling disparity in the median amounts that women and men have saved in retirement accounts like 401(k)s and Individual Retirement Accounts—women have only $10,000 and men have $18,000.

The importance of pensions in providing a secure retirement

Pension income during retirement can be the key income source that provides a truly secure retirement. The prevailing trend over the past two decades has been for employers to discontinue offering traditional defined benefit plans in favor of the more portable defined contribution plans and, the most popular plan of all time, the 401(k). The trend toward defined contribution plans shifts the risk and the return on the investment to the employee and often participation is contingent on the employee making a contribution.

Defined benefit pensions, in particular, provide guaranteed monthly payments for the rest of the worker's life and offer a survivor benefit for his or her spouse. This feature is important for all retirees, but, for all of the reasons discussed above, it is especially important for women. In addition, the employer has the investment and management responsibility. Low-income workers do not face the challenge of taking money out of their paychecks or deciding how to invest it.

We have heard from many women and men who do not participate in their defined contribution plans because they either do not feel they can spare any money from their paychecks or do not understand the investment choices—they do not face these hurdles in a defined benefit plan.

Defined contribution plans have certain advantages for some workers.

WISER is a strong advocate of measures that increase meaningful pension coverage for women, the majority of whom are lagging behind in retirement benefits. Fewer than one in five women age 65 and over received pension benefits in 2000.

Without changes in the current system, young women will face similar risks of poverty in retirement.

H.R. 3488, the Retirement Opportunity Expansion Act of 2001 will help women gain pension benefits by increasing pension coverage and participation and by improving the opportunities for saving by:

- helping to expand pension coverage by providing a refundable tax credit to low income individuals;
- treating family and medical leave as hours of service;
- providing credit for qualified pension plan contributions of small employers and,
- including a provision allowing payroll deduction contributions to individual accounts with an immediate tax benefit that would provide a needed incentive to help more employees begin to save for their retirement.

The revolution in women's roles in society over the last generation has not relieved them of their responsibilities as family caregivers. Women are still more likely to leave the workforce or to work part-time to accommodate care-giving responsibilities. In addition to maternity leave, they also bear the primary responsibility for an ill child or a sick relative—resulting in shorter job tenures. For example, women stay in jobs an average of only 4.4 years, whereas pension vesting rules generally require 5 years on the job.

The effect of low wages on pension benefits

We all know that access to a 401(k) plan is certainly better than no retirement savings vehicle at all—but only if you can afford to contribute to it. One survey of the nation's largest employers found that the worst plans are offered in the retail and service industries, where the workers are less likely to have pensions, the pay is low and the jobs are dominated by women. The survey's result indicated that the workers least able to save have the lowest matching contributions.

But most women aren't lucky enough even to have a pension, regardless of its size. The recent corporate legacy of downsizing and economic restructuring has had a disproportionate impact on women. Currently, 40 percent of all women's jobs are now non-standard. These non-standard jobs are part-time, contract, freelance, and often in combination to create one full-time job. But more importantly, these jobs mean low wages, fewer employee benefits and most often no company pension plan.

Women's jobs are low-wage, service, part-time jobs and/in small businesses—where pension coverage is the most sparse. Although full time working women have made great strides in nearly reaching parity with men, it is partly due to the declining pension coverage for men. When all working women are compared to all working men there's a 7 percent gender gap

The effect of women's longer lives

Financial experts tell Americans generally to plan to replace 70 or 80 percent of their income at retirement. Unfortunately, this advice doesn't work for women, who are likely to need more than 100 percent of their pre-retirement income in order to remain secure throughout their longer lives.

The higher life expectancy of women necessarily means that at some point during their retirement, the vast majority will find themselves alone. In fact, about 80 percent of men die married and 80 percent of women die single.

Divorced older women

As a group, separated and divorced older women have the most serious economic problems. When couples divorce, the wife typically experiences a 26-percent decline in her standard of living compared to a 34-percent increase for their ex-husbands. This translated into women having less money to spend on essentials and even less to save for retirement. Also, many women overlook the fact that they can claim a share of their husband's pension as part of the divorce settlement.

It is also important to note that our nation's poverty rate for single elderly women, which stands at about 18 percent, is by far the highest percentage in the industrialized world. And the breakdown of poverty rates among minority groups is even more stark.

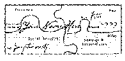
For all of the reasons outlined above, defined contribution plans may not always be the best option for women, who might in fact be better served by the features available in a defined benefit plan—a defined benefit plan has a lot going for it as far as women are concerned, including a guaranteed pay out in monthly installments over the remainder of one's life.

Finally, we commend this Subcommittee for focusing attention on this critically important issue. The implications of inadequate pension income are far-reaching

and directly related to income. We need to address these issues now and take steps that will narrow the gap between those retirees who are financially able to save adequately and those who are poor.

Thank you.

WOMEN'S INSTITUTE FOR A SECURE RETIREMENT



YOUR FUTURE PAYCHECK
EXECUTIVE SUMMARY

Your Future Paycheck: What Women Need to Know About Pay, Social Security, Pensions, Savings and Investments looks at the conditions that have prevented women from planning a secure retirement. Drawing upon a variety of sources, ***Your Future Paycheck*** shows why older women today are almost twice as likely as men to be poor, and examines why this trend is likely to continue for younger women.

The choices women face now regarding their current paycheck can have grave implications for their future paycheck. Factors such as caregiving, pay inequities, lack of pension coverage, marital status and employment patterns are more likely to affect women adversely. Women live longer, but often end up with less income in retirement—in 2000, the median personal income for women age 65 and older was $10,899, compared to $19,168 for men.

This report provides a clear picture of the status of women and retirement today:

- **Pay Issues:** More women are now in the workforce, but women still earn less than men in almost every occupational classification. On average, women earn 73 cents for every dollar men earn. A typical 25-year-old woman with a college degree will earn about $523,000 less over her lifetime.
- **Older Women and Poverty:** Despite the overall decline in poverty rates among older Americans during the last several decades, many older women remain poor—in 2000, 12.2 percent of women over 65 were poor, with older unmarried women and minority women facing the highest rates of poverty. Today, nearly 60 percent of older American women are either widowed, divorced, separated, or never married.
- **Women and Social Security:** Women depend more on Social Security than men, and lag behind men in the amount of Social Security income they receive. Ninety percent of older women receive Social Security. Of this, one in four women rely on Social Security as their only source of income, and over half (52.5 percent) would be in poverty were it not for their benefits. While the average benefit for men is $951 a month, for women, the average benefit is $730, or roughly 23 percent less than a man's.
- **Pension Income Differences Between Men and Women:** Because women switch jobs more often, they have a greater chance of forfeiting their pension benefits. In 2000, less than one in five retired women received income from private pensions (18 percent). However, almost one in three men received income from private pensions (31 percent). Of those who received such income, the median benefit for women was $4,164—or 46 percent of the median benefit for men ($7,768).
- **Young Women and Saving:** While retirement planners all agree that starting young can give you maximum retirement earnings, women do not save enough. School loans, car payments, rent and mortgages can all take precedence over securing a retirement income. Indeed, many women ages 21–34 were more likely to carry credit card debt than men (47 percent to 35 percent, respectively), and more single women than men live paycheck-to-paycheck (53 percent to 42 percent).
- **Saving and Investing:** Women's lower earnings often leave them with fewer resources to invest. The current generation of unmarried elderly women has less than $1,278 in asset income. The demographic trends are mixed—while married midlife women are increasing their net worth, unmarried and divorced women are lagging behind. While younger women are more aware of

the importance of saving for retirement, they also report carrying more debt than young men, and continue to work in professions that pay less.

- **Differences of Race in Retirement Income:** Many minority women face great challenges when saving for retirement. The poverty rate among single elderly minority women. For black women, the rate is 43.1 percent. For Hispanic women, it is 37.7 percent. For all single elderly women, it is approximately 20 percent.

In response to these trends, the report discusses a number of proposals to better the status of women during retirement, with a focus on improving Social Security and pension benefits.

- Reform proposals for Social Security need to focus on improving benefits for caregiverss, widowed or divorced women, and low-wage workers.
- Pension reform proposals, such as tax credits encouraging employers to extend pension coverage to part-time and temporary workers, could greatly benefit women who do not have pension coverage. Educating women about pension participation in 401(k)'s, pension coverage in small firms, and pension integration could increase their benefits.
- Enacting pay equity legislation would increase Social Security and pension benefits, as well as increase the money women could save and invest.
- Finally, because women face immense challenges in planning for a secure retirement, it is vital that women become better educated about what they have now, what they need to save, and how to invest.

With current debates over Social Security privatization and worker participation in company 401(k) plans, there has been growing emphasis on placing the burden of investing onto the individual. Because of this, all individuals, especially women, need to know how precarious retirement security has been in the past, in order to make informed decisions about their financial futures.

WISER Fact Sheet

Men's & Women's Income in 2000

- **Over 2 out of 3 working women earn less than $30,000 a year.**
- **Nearly 9 out of 10 working women earn less than $45,000.**

	All Working Women	All Working Men
Income Earned	(percent)	(percent)
Under $10,000	26.1%	15.4%
$10,000 to $14,999	12.1%	7.6%
$15,000 to $29,999	30.9%	24.4%
$30,000 to $49,999	20.6%	25.5%
$50,000 to $74,999	7.6%	15.3%
Over $75,000	2.8%	11.7%
Under $30,000	69.0%	47.4%
Under $35,000	76.7%	55.6%
Under $40,000	82.3%	62.4%
Under $45,000	86.8%	68.4%
	Median Earnings $20,311	Median Earnings $31,040
	Median Full-time Earnings $27,355	Median Full-time Earnings $37,339

Source: Money Income in the United States, US Census Bureau, 2001

Chairman HOUGHTON. So, now we turn to Mr. Gutknecht, a distinguished, knowledgeable, and caring Member of the U.S. House of Representatives from Minnesota. Gil?

STATEMENT OF THE HON. GIL GUTKNECHT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. GUTKNECHT. Thank you very much, Mr. Chairman and Ranking Member Coyne. I want to thank you for holding this hearing. I don't come here today as a pension expert, but I will by way of disclaimer at least, say that I was privileged during my time in the State legislature to have served on the Legislative Commission on Pensions and Retirement, which usually in Minnesota is referred to as the Pension Commission.

I am familiar with the difference between defined benefit and defined contribution plans. I understand some of the long-term ramifications in the rules and that employers do have the right to change or amend their pension plans at any time.

I appear today on behalf of roughly 7,000 IBM employees in my district and I will share that story with you later.

I would like to focus our conversations today on defined benefit retirement plans and those conversions to what are referred to as cash balance plans. Over the past several years our country has witnessed the unfortunate spectacle of major corporations converting defined benefit plans to what are called cash balance plans in order to recapture billions of dollars from supposedly over-funded pension plans.

Hundreds of thousands of employees, many of whom are older and vested, and I want to come back to that term, "vested," in their plans saw the value of their retirement benefits drop precipitously. In my dictionary and in virtually every dictionary, if you look up the term "vested," you will get this definition. It is an adjective. It means settled, fixed or absolute, without contingency, a vested right.

Despite this definition, being vested in a pension plan does not mean what most American workers think it means. Companies can at any time and for any reason, change a vested employee's pension plan. Such conversions often result in anywhere from a 20- to 50-percent reduction in final total benefits, with long wear-away periods during which employees do not accrue any new benefits.

Mr. Chairman and Members, this is simply wrong. When companies change their retirement plans in a way that may reduce employee's benefits, vested employees should be allowed to stay in the original pension plan that they were promised.

As Mr. Coyne mentioned, Bureau of Labor and Statistics indicate that more than 48 million American workers are age 45 or older. Over 40 million workers or their spouses participate or receive benefits from defined benefit plans.

Several years ago, as I mentioned earlier, thousands of IBM workers in my district came to work one morning to find that the defined benefit pension plan that they had been enrolled in had been changed to a cash-balance plan without warning, and more importantly, without any consultation.

For years, these employees had been able to calculate their future benefits with a pension calculator which was located on their computer on their desks, compliments of IBM. When the plan changed, a few days later the calculator disappeared. So did the employees promised benefits.

Congress needs to take action that simultaneously gives all employees fair warning of pension plan changes and gives vested employees protection from company actions that rewrite the pension rules in the middle of the game.

That is why I have introduced H.R. 4181, the Vested Worker Protection Act of 2002. This bill would simply require that healthy companies would be required to give, number one, 90 days notice of a defined benefit pension plan change to all workers.

Number two; give fully vested employees the choice of staying with their current plan or switching to the new plan that has been amended. This bill exempts companies that are in financial distress from any penalties, while otherwise healthy companies would be subject to an excise tax, should they violate the provisions of this bill.

Most Americans take protection of their pension plan for granted. I think the Enron situation has demonstrated the need for employees to carefully monitor how their employer handles their retirement benefits.

As many major companies change their pension plans and reduce future benefits, planning for retirement based on promises made by their employees becomes extremely difficult. Providing employee choice in the event of a planned conversion would go a long way to reestablishing balance and fairness for workers with respect to their pensions. With that, Mr. Chairman, I will be happy to yield and take some questions.

[The prepared statement of Mr. Gutknecht follows:]

Statement of the Hon. Gil Gutknecht, a Representative in Congress from the State of Minnesota

Chairman Houghton, Ranking Member Coyne, and Members of the Subcommittee:

Thank you for allowing me to testify at this very important hearing on retirement security and defined benefit pension plans. I would like to focus on conversions from defined-benefit retirement plans to "cash-balance" plans.

Over the past several years, our country has witnessed the unfortunate spectacle of major corporations converting defined-benefit plans to cash-balance plans in order to recapture billions from supposedly "over-funded" pension plans. Hundreds of thousands of employees, many of whom were older and "vested" in their plans saw the value of their retirement benefits drop precipitously.

In my dictionary, "vested" is defined as follows:

Vested. *adj*. 1. Settle, fixed, or absolute; being without contingency: *a vested right*.

Despite this definition, being "vested" in a pension plan does not mean what most Americans think it means. Companies can, at any time and for any reason, change a vested employee's pension plan. Such conversions often result in anywhere from a 20–50% reduction in final benefits, with long "wear-away" periods during which employees do not accrue any new benefits.

This is wrong. When companies change their retirement plans in a way that may reduce employee benefits, vested employees should be allowed to stay in the original pension plan that they were promised.

Bureau of Labor statistics indicate there are more than 48 million American workers over the age of 45. The latest Bureau of Labor statistics also show that more than 40 million workers or their spouses participate or receive benefits from defined benefit plans. Many of these 40 million workers fall into the over-45 age category.

Several years ago, thousands of IBM workers in my district came into work one morning to find that the defined benefit pension plan they had been promised had been changed to a cash-balance plan without warning. For years these employees had been able to calculate their future benefits with a pension calculator located on their computer, compliments of IBM. When the plan changed, the calculator disappeared. So did the employees' promised benefits.

Congress needs to take action that simultaneously gives all employees fair warning of pension plan changes and gives vested employees protection from company actions that rewrite the pension rules in the middle of the game. That is why I introduced H.R. 4181, the Vested Worker Protection Act of 2002. This bill would require *healthy* companies to:

1. provide 90 days notice of a defined-benefit pension plan change to all workers
2. give fully vested employees the choice of staying in their current plan or switching to the new, amended plan

This bill exempts companies in financial distress from penalties, while otherwise healthy companies will be subject to an excise tax should they violate the provisions of this bill.

Most Americans take protection of their pension plan for granted. The Enron situation has demonstrated the need for employees to carefully monitor how their employer handles their retirement benefits. As more companies change their pension plans and reduce future benefits for employees, Congress must provide, at a minimum, protection for vested workers who are planning for retirement based on promises made by their employers. Providing employee choice in the event of a plan conversion will go a long way toward re-establishing balance and fairness for workers with respect to pensions.

Thank you.

Chairman HOUGHTON. Thank you very much. Let me just ask a question and then I will turn it over to you. If I understand it, really, you can have a cash-balance program without some of the pitfalls, which you have indicated. What happened with IBM?

Mr. GUTKNECHT. I hate to speak too specifically about what happened in IBM. The real issue, I think, Mr. Chairman, is the term "vested." Almost every American believes that once they are vested for a pension plan, and especially based on what are, at least expected promises that that pension plan will go on forever.

Most people believe that they are not going to change their pension plan. The issue here was that it was changed overnight, without any notice. As an example, on the plane back last week, I got off the plane and was walking with an IBMer and he said, "I hope you will continue to fight on that pension issue. That cost me $150,000."

As I said, in their case, IBM had literally put, as part of the software tools on their computers, a calculator where they could calculate, if they stayed with the company until they were 65, how much their pension benefit would be worth.

Chairman HOUGHTON. Gil, talk about the Employee Retirement Income Security Act 1974, (ERISA) issue.

Mr. GUTKNECHT. Again, I hate to hold myself out as an expert on ERISA, but here is what I understand and it was always my understanding, the reason that the Congress passed ERISA preemption in the first place. Major employers back in the sixties and seventies were doing a fabulous job, IBM included. Many major employers were doing a wonderful job of taking care of their employees with health insurance benefits, with life insurance benefits, some with dental insurance and generous pension plans.

Essentially, major employers came to Washington and said, "Listen, we don't want to have to deal with regulation in 50 different States. As long as we continue to take good care of our employees with these generous pension plans and life insurance plans and so forth, we would like to be preempted from State regulation."

All of a sudden, it seems to me that it is not the workers that are breaking their end of that bargain. It is not Congress that has changed the bargain. It is the major employers.

Now, as I say, it is one thing if those employers are facing a very difficult financial situation. I think we all recognize that when the ship is sinking we have to do some things to change. In many cases we are talking about major employers that are extremely profitable and otherwise have no problem meeting their obligations in these programs, which in most cases are over-funded now.

Chairman HOUGHTON. We have a vote and we probably have 10 minutes for questioning. So, let us go right at it. Bill, have you got questions?

Mr. COYNE. Thank you, Mr. Chairman. I just want to thank the gentleman for bringing to the Congress a real, live example from his district of the shortcomings in the laws that exist today relative to the pension relationships between employer and employee. Thank you.

Mr. GUTKNECHT. Well, thank you, Mr. Coyne. If I could just respond, you know, as I say, many of us were surprised when this happened. Many of my constituents said, "Well, I thought this was illegal."

The more they studied it, they found, no it isn't technically illegal and that is when people started saying there ought to be a law and that is what we do.

Mr. COYNE. IBM later agreed to make some changes regarding who can opt into the old defined benefit plan or go to the new cash-balance plan. Do you know how such a decision impacted your constituents that were adversely affected by the conversion?

Mr. GUTKNECHT. Well, under enormous pressure, both from the employees and from people like me and other Members of Congress from other districts that represented IBMers, they did reduce the age and people, I think, above the age of 40 were allowed to stay in their defined benefit plan.

Now, if I could say this, Mr. Chairman, you know, some people say, well, this is a lot of bureaucracy and red tape that employers have to go through. All of these employers are going to continue to have a defined benefit plan for many years to come anyway, for the employees who are already in the system that were vested for the benefits that they were already vested for, this program will go on.

So, in many cases, it is really a matter of whether they are going to continue their defined benefit plan for 30 years or 40 years. It is not a question whether or not they will have to continue participating in a defined benefit plan, it is just a matter of how long.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Please, Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. First, let me begin by thanking you for conducting this hearing, but also commending my colleague from Minnesota for his leadership in drawing attention to the important of retirement security issues.

You have worked on this issue for a long time and I appreciate your perseverance and your persistence on behalf of your constituents.

Let me just ask one question since I recognize we are limited here on time. On the issue of pensions and the conversion issue

from a defined benefit, many have said that those who are impacted the most are long-time workers and that those who relatively new employees actually may find it more attractive.

I was just wondering, from your perspective in working with your constituents, have you seen that and can you give an example or two?

Mr. GUTKNECHT. Well, let me say, Mr. Chairman, I am not adverse to defined contribution plans. I think you would find, if you gave employees the choice, many of the younger workers would go to the defined contribution plan. It is those workers who are between the ages of, say, 40 and 45 or 40 and 50 that are long-term employees that really get hurt when there is this conversion that happens because if you look at what happens with a defined benefit plan, you accrue most of your benefits during the last 5 years of your employment.

So, that is where this wear-away factor happens, where employees lose hundreds of thousands of dollars. Literally, I have talked to IBM employees who have told me they have lost hundreds and hundreds of thousands of dollars in total benefits. So, it really does affect those people who have been with the company 20 years, who are, what some would describe as approaching middle age, and there are a lot of those baby boomers out there and this could have a profound impact on them.

The real concern I have, and I still consider IBM to be a wonderful employer. They are a good company, a solid company, but you have to ask yourself, if it could happen at IBM, it could happen anywhere.

Mr. WELLER. Just a quick follow up on that. From the relatively new employees, have you seen just from your examination that when there is conversion over the cash balance and for a relatively new employee who may stay with the company for a long period of time, did you see an advantage to a cash balance over a defined benefit?

Mr. GUTKNECHT. Well, that is a hard one to answer. It would vary by program. I am not an expert. You would have to get an actuary in here to explain that. In a mobile workforce environment defined contribution plans are the answer, depending on how the pension plan is structured.

If somebody is going to stay with the company for a long period of time, 30, 40 years, in almost every case they would be better with a defined benefit plan as they are currently structured. That is the minority of employees entering the workforce today.

The problem is that you have some of these older companies like IBM, like General Electric, big companies where historically there are a lot of people who started with the company when they got out of school and they stayed with the company until they retired. Those people are dramatically affected when you have these conversions.

Of course, that is the reason the companies do that, because they realize they can save billions of dollars. My estimate is that IBM probably is saving somewhere around $5 billion over the next 6 years by making this conversion.

Mr. WELLER. Thank you.

Chairman HOUGHTON. Mr. Pomeroy.

Mr. POMEROY. Gil, I think you have done a great job on this issue. You have absolutely been a bulldog on it and really helped elevate national attention about troubling issues presented in these conversions where there are not particularly hold harmless protections made so that people don't find dramatic benefit reduction.

There are 56 percent, about half the people in the workforce, have at work retirement savings options of some kind. About 56 percent of those have DC plans. About 30 percent have a defined benefit and a defined contribution plan available. About 14 percent, defined benefit only.

Now, the position that I take on the questions that my friend, Congressman Weller was asking is that the defined benefit plan has an awful lot going for it in terms of being able to provide annuity protection to workers in their retirement years for as long as they live.

My goal is to take another look at what we can do to reinvigorate market interest in defined benefit plans. One of the things that caused me some concern about over-responding, about laying in a whole host of guarantees to address the circumstance that we saw with the IBM case is that you would never have a new defined benefit plan offered anywhere because no one is going to buy that forever liability.

You offer a defined benefit 1 year and you are going to have to keep it in place as an option at least until the worker retires. Would you respond to that concern relative to your legislation?

Mr. GUTKNECHT. Mr. Pomeroy, you know, I have to agree. I think that is one of the concerns. That is when it comes back to the whole ERISA bargaining. If they are not offering a pension plan now, then Congress really doesn't have much to say about it. The real concern I have is there is no one out there protecting the middle-aged worker who is currently in a defined benefit plan. I don't know that there is much we can do to encourage more employers to offer defined benefit plans.

I do know that if we don't discourage the kind of thing that we saw happen with IBM, we are going to see a whole lot more of it. That number of people in defined benefit plans is going to go down. You have consultants working for what used to be the major accounting firms that are out there telling people how they can make these conversions and ultimately shift money from over-funded pension plans to their bottom line.

Mr. POMEROY. Well, the shift in defined benefit to defined contribution which, in my opinion, raises even more questions than moving to the hybrid hasn't run its course, but we have had a heck of a lot of it really fundamental reshaping the market. Part of your bill involves notice. I don't think we should under-appreciate what very clear advance notice does in the workforce.

For example, if I am intending a plan that does not deal adequately with the wear-away factor, that does not treat the more tenured employees fairly, and I give them very clear notice of that in advance. As an employer HR department, I am buying a host of trouble. All my most senior operatives, I am about to tell them, "I am going to rip you off on your retirement benefit conversion."

There is an awful lot that will spring automatically from that. They are going to take things into their own hands. They don't

need a new statute, necessarily to do that, provided we provide the statutory requirement on notice. So, I think that that part of your bill gets a lot done right there, even without the guaranteed continuation of the option.

Chairman HOUGHTON. Thank you.

Mr. POMEROY. Thanks, Mr. Chairman. I yield back.

Chairman HOUGHTON. Well, thanks very much. I appreciate this. We have a vote on. We will come back and we will take the next panel after this.

Mr. GUTKNECHT. Well, again, on behalf of IBM employees, thank you very much for having this hearing.

Chairman HOUGHTON. Thank you.

[Recess.]

Chairman HOUGHTON. All right, ladies and gentlemen, we are going to continue. There will be no more votes in the House for the day, so therefore we will have an uninterrupted session here. I would like to introduce Mr. Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corp. Welcome, Mr. Kandarian. You can begin your testimony at any time.

STATEMENT OF STEVEN A. KANDARIAN, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Mr. KANDARIAN. Thank you. Mr. Chairman, Mr. Coyne and Members of the Subcommittee, thank you for inviting me to appear today to talk about defined benefit plans. The PBGC is a government corporation that ensures the pensions of about 44 million participants and beneficiaries in approximately 35,000 ongoing defined benefit plans.

Our Board of Directors is comprised of the Secretary of Labor who is Chair, and the Secretaries of the U.S. Department of Commerce and the U.S. Department of the Treasury. We receive no funds from general tax revenues. Operations are financed by premiums from plan sponsors, assets from plans we trustee, recoveries in bankruptcy, and investment income.

In its single-employer program, PBGC operated in a deficit position during its first 21 years. In 1996 we recorded our first surplus which grew to over $10 billion in the year 2000, but has rapidly declined since.

Today, less than 2 years later, our unaudited surplus has been cut by more than half and is now under $5 billion. Moreover, I expect this number to decline further.

We also face over $9 billion in underfunding in the steel industry. About half of that is in steel companies that are currently in bankruptcy. In addition, we face large underfunding in troubled companies in the airline and retail sectors.

Terminating large pension plans creates an administrative challenge as well. Last year we became responsible for paying the benefits of 89,000 participants, the largest number of new participants in a single year in our 27-year history. We project taking in about 200,000 new participants this fiscal year. The number could be even higher next year.

In addition, we are closely monitoring troubled companies with under-funded plans. The ERISA authorizes PBGC to act to avoid an unreasonable increase in long-run loss to the insurance system.

We are examining each situation to determine whether we need to terminate plans now to avoid an even greater loss in the future.

Last week we moved to terminate the highly underfunded pension plans of Republic Technologies International to avoid an additional loss of approximately $100 million to the insurance system.

From an administrative viewpoint, we continue to focus on accelerating our use of technology in providing the best customer service possible. For example, in LTV for the first time, we sent out letters to participants before we took over the plans so workers would know what to expect.

I will now talk about the decline of defined benefit plans. The number of plans we insure peaked in 1985 at about 114,000. Since then, there has been a sharp decline to approximately 35,000 plans. Plans with fewer than 100 participants have declined most rapidly. The percentage of the private sector workforce that has a defined benefit plan declined from 38 percent in 1980 to 22 percent in 1998.

The total number of participants has actually grown slightly, but this masks a troubling decline in the number of active workers in defined benefit plans. We project that by next year there will be more retired and separated participants than active workers in the defined benefit system.

A number of factors have led to the decline of defined benefit plans. Employment has shifted away from large, unionized industrial companies that have traditionally offered these plans. Employer attitudes toward retirement security have become less paternalistic.

Younger, more mobile workers prefer the portability and investment control of 401(k) plans, and companies seek pension cost that they can control, as they increasingly compete with domestic and foreign businesses that do not offer defined benefit plans.

The only type of defined benefit plan that has increased in popularity in recent years is the cash balance plan. Over 30 percent of the Fortune 100 companies have adopted cash balance plans. Cash balance plans provide an account balance and greater portability than traditional plans, which makes them attractive to mobile workers.

We view cash balance plans as the most viable avenue to reverse the decline of the defined benefit system.

Mr. Chairman, today PBGC faces its greatest challenge in a decade. I can assure this Subcommittee that we are working hard to protect the health of the defined benefits system. I would be happy to answer any questions from the Subcommittee.

[The prepared statement of Mr. Kandarian follows:]

Statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation

Mr. Chairman, Mr. Coyne, and Members of the Subcommittee:

It is a pleasure to appear before this Subcommittee today. I became Executive Director of the PBGC on December 3, 2001, a little over six months ago. You have asked me to provide you with information on the status of defined benefit plans.

Defined benefit plans have historically played an essential role in the three-legged stool of retirement income. The hearings you are holding today provide a welcome focus on the future role of defined benefit plans.

OVERVIEW OF PBGC

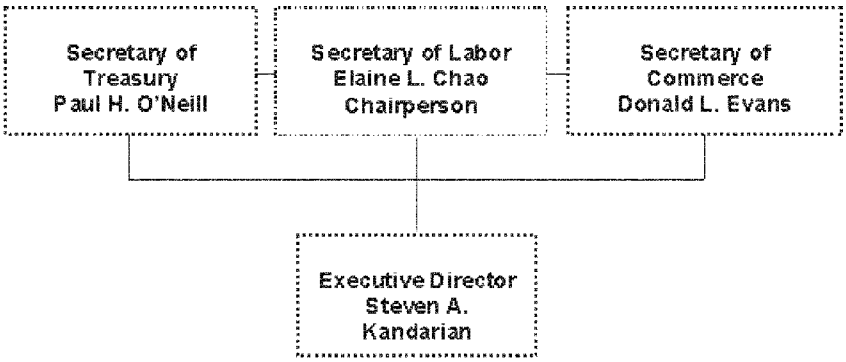
I would like to take a few minutes to give you some background on the PBGC and its role in the pension system. PBGC was created by ERISA, the Employee Retirement Income Security Act of 1974, to guarantee private defined benefit pension plans that terminate without sufficient assets. Defined benefit plans provide a monthly retirement benefit, usually based on salary and years of service. The benefit amount does not depend on investment performance.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Pension and Welfare Benefits Administration (PWBA). Treasury and PWBA deal with both defined benefit plans and defined contribution plans, including 401(k) plans. PBGC deals only with defined benefit plans, and only to a limited extent, as guarantor of benefits in underfunded plans that terminate. PBGC has very limited regulatory or enforcement authority over ongoing plans; the authority PBGC does have relates to certain employer reporting requirements and to determining whether a plan should be terminated to protect the insurance program.

PBGC protects the benefits of about 44 million participants and beneficiaries in slightly more than 35,000 ongoing defined benefit pension plans. When a plan insured by PBGC terminates without sufficient assets, PBGC becomes trustee of the plan and pays plan benefits, subject to statutory limits. For the vast majority of participants in PBGC-trusteed plans, plan benefits are paid in full. On average, participants receive over 94 percent of the benefits they had earned at termination. However, some participants receive a considerably smaller portion of their earned benefit. In addition, the 94 percent figure does not take into consideration benefits for which the participant had not yet satisfied all conditions at the time of termination, such as 30-and-out benefits.

At the end of FY 2001, PBGC was responsible for paying current or future pension benefits to about 624,000 people in terminated plans, and payments, for the first time, exceeded $1 billion. PBGC has added over 140,000 new participants already in this fiscal year.

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



PBGC receives no funds from general tax revenues. Operations are financed by insurance premiums set by Congress and paid by sponsors of defined benefit plans, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans. There is a two-part annual premium for single-employer plans—a flat-rate premium of $19 per plan participant plus a variable-rate premium of $9 per $1,000 of the plan's unfunded vested benefits. PBGC has a separate, smaller insurance program for multiemployer plans, which are collectively bargained plans maintained by two or more unrelated employers.

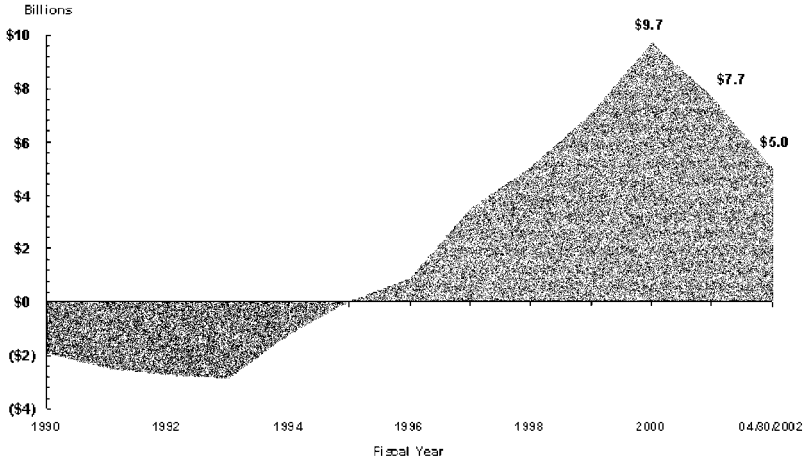
PBGC's statutory mandate is: (1) To encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants, (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under PBGC-insured plans, and (3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations.

Financial Condition of the PBGC

For its first 21 years, PBGC operated at a deficit. Beginning in 1996, PBGC has gradually built up a surplus as a result of legislative reforms, a strong economy, good returns on investments, and no major terminations from 1996–2000. PBGC had a surplus of $9.7 billion in its single-employer program at the end of fiscal 2000 (September 30, 2000). At the end of fiscal 2001 (September 30, 2001), the surplus had dropped to approximately $7.7 billion. As of April 30, our unaudited surplus had fallen to under $5 billion.

Net Position FY 1990—2002

Unaudited Projection



NOTE: PBGC WAS IN DEFICIT FOR ALL YEARS PRIOR TO 1990

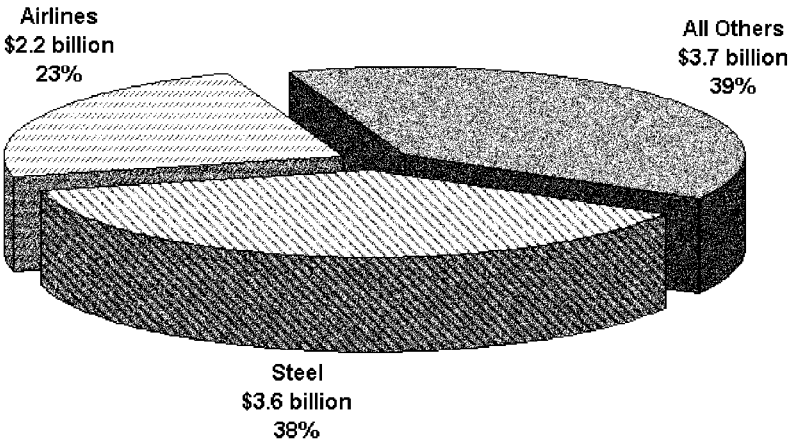
SOURCE: PBGC Annual Reports (1990—2001), 2002 projection

I'm concerned that our surplus may decline even further. Including the approximately $1.6 billion in claims from the LTV plans, the steel industry now accounts for about 38% of all claims against PBGC.

And we still face over another $9 billion in underfunding in the steel industry, nearly half of which is in steel companies that are in bankruptcy proceedings. We also face large amounts of underfunding in troubled companies in the airline and retail sectors.

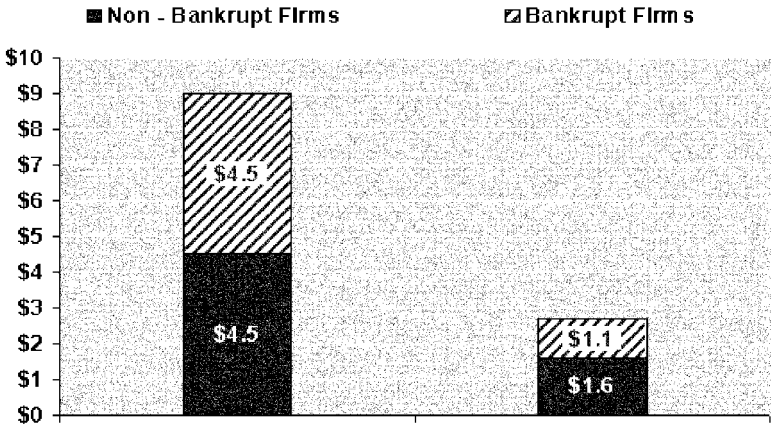
PBGC Claims

1975—2002



SOURCE: PBGC Annual Reports (1990—2001), 2002 projection

Integrated Steel Plan Underfunding



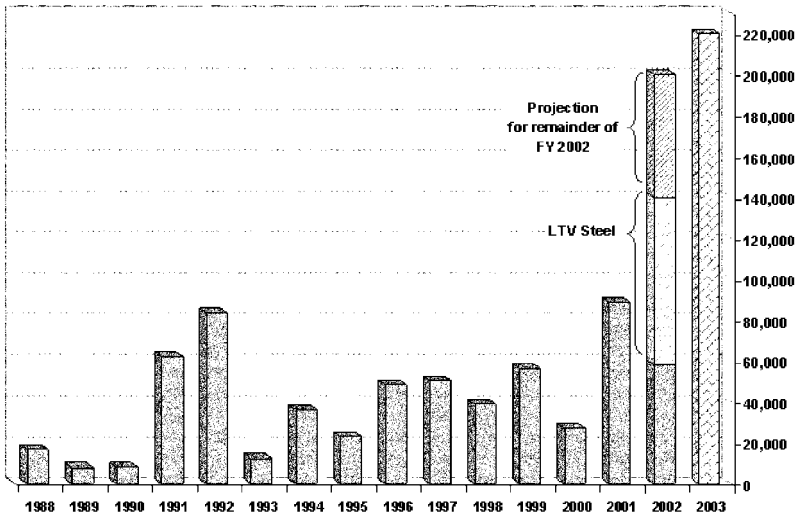
Pension Underfunding | **Shutdown Benefits (potential additional underfunding)**

SOURCE: PBGC Analysis of Actuarial Valuation Reports

Administrative Workload

Not only does the PBGC face a challenge financially, we face a challenge administratively. Large plan terminations have always been, and continue to be, the single most important factor determining PBGC's workload as well as its financial condition. PBGC became responsible for 104 plans with 89,000 participants last year, the largest number of new participants in PBGC's 27-year history. This year, we already have become responsible for over 140,000 new participants, and the end-of-year figure could be as high as 200,000. Little relief is in sight. If the plans of some of the troubled steel companies, airlines and others are terminated, new participants coming to PBGC in fiscal year 2003 could exceed this year's 200,000 new participant figure.

New Participants in Trusteed Plans
Fiscal Year 1988—2003 (projected)



SOURCE: PBGC Insurance Operations Department Reports

PBGC Actions to Address these Problems

We are taking steps to deal with this financial and administrative challenge. From a financial perspective, PBGC is closely monitoring troubled companies with underfunded plans. And PBGC is carefully examining each situation to determine if PBGC must terminate plans now in order to avoid even greater losses to the PBGC insurance program in the future. PBGC is totally financed by our premium

payers—the sponsors of defined benefit plans. We have an obligation to those premium payers to be fiscally responsible and take the necessary difficult actions to keep PBGC financially sound.

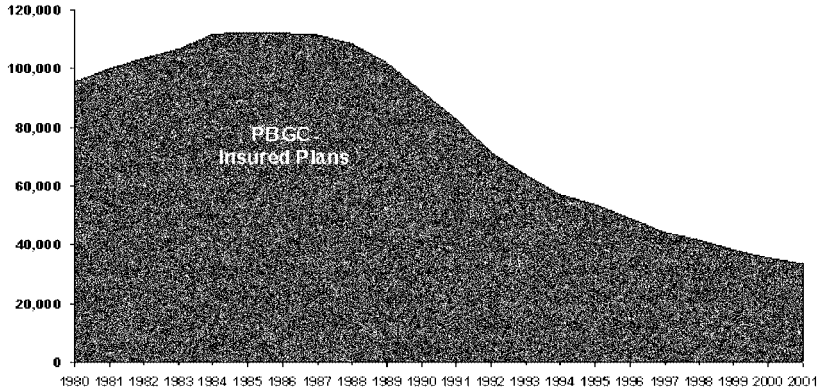
From an administrative viewpoint, we continue to accelerate our use of computer technology, contractors, and other measures to get participants into pay status as soon as they are eligible, to reduce waiting times for final benefit determinations, and to provide superior customer service. Participants feel a great deal of stress when their pension plan terminates, frequently at the same time they lose their jobs. PBGC should be a source of reassurance, not another source of stress. To this end, we are both continually learning from what participants and plan sponsors tell us and proactively designing new ways of providing better information. For example, in LTV, for the first time, we sent out letters to participants *before* we took over the plan so they would know what to expect.

Trends in Defined Benefit Plans

I would now like to turn to what is happening to defined benefits plans.

Number of Defined Benefit Plans

The percentage of private-sector workers with pension coverage in their current jobs has remained constant at just under 50 percent since the mid-1970s. But there has been a large and continuing shift away from defined benefit plans to defined contribution plans. The number of PBGC-insured defined benefit plans peaked in 1985 at about 114,000. Since then there has been a sharp decline to slightly more than 35,000 plans in 2001, a decline of almost 70 percent.



SOURCE: PBGC Premium Filings

This reduction in the number of plans has not been proportional across all plan sizes. Plans with fewer than 100 participants have shown the most marked decline, from about 90,000 in 1985 to 20,500 in 2001. There also has been a sharp decline for plans with between 100 and 999 participants, from more than 19,000 in 1985 to less than 10,000 in 2001.

In marked contrast to the trends for plans with fewer than 1,000 participants, the number of plans with more than 1,000 participants has shown modest growth. Since 1980, the number of PBGC-insured plans with between 1,000 and 9,999 participants has grown by about 1 percent, from 4,017 to 4,070 in 2001. The number of plans with at least 10,000 participants has grown from 469 in 1980 to 809 in 2001, an increase of 72 percent.

The growth in the number of large plans is attributable to two factors. First, the rapid increase in inactive participants (retirees and separated vested participants) has pushed some plans into higher size categories. Second, in instances where one employer maintained more than one plan, frequently as a result of corporate mergers and acquisitions, the employer has merged those plans.

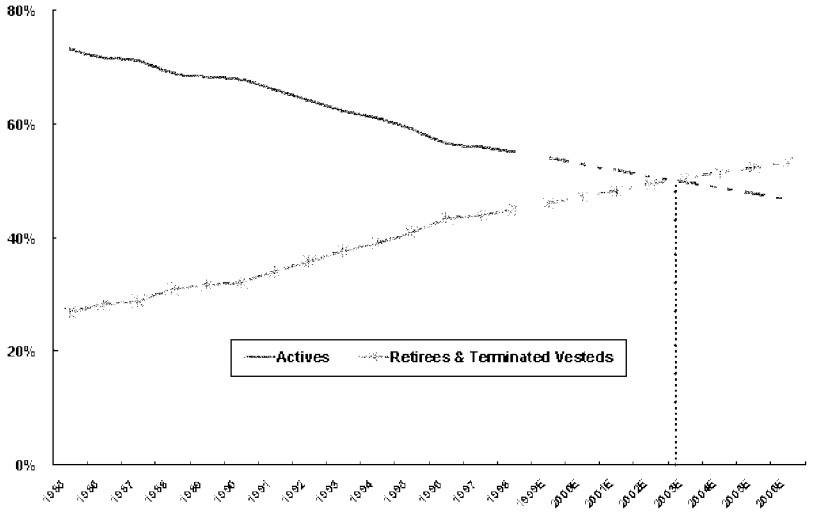
Number of Participants

In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured defined benefit plans has shown modest growth. In 1980, there were 35.5 million participants. By 2001, this number had increased to about 44 million.

These numbers, however, mask the downward trend in the defined benefit system because total participants include not only active workers but also retirees (or their surviving spouses) and separated vested participants. The latter two categories of participants reflect past coverage patterns in defined benefit plans. A better forward-looking measure is the trend in the number of active participants, workers currently earning pension accruals. Here, the numbers continue to decline.

In 1985, there were 29.0 million active participants in defined benefit plans; by 1998, this number had fallen to an estimated 23.0 million, a decrease of 21 percent. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 27 percent of total participants in defined benefit plans. This number has increased to 45 percent by 1998. If this trend continues, by the year 2003 the number of inactive participants will exceed the number of active workers.

Ratio of Participants in Defined Benefit Pension Plans
1985–2006 (estimated)

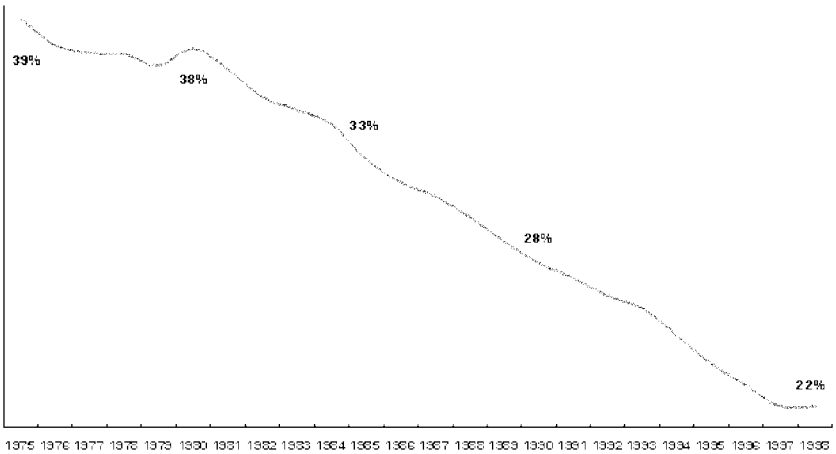


SOURCE: U.S. Department of Labor, Pension Welfare & Benefits Administration, Abstract of 1998 Form 5500 Annual Reports, Winter 2001–2002

Decline of Defined Benefit Plans

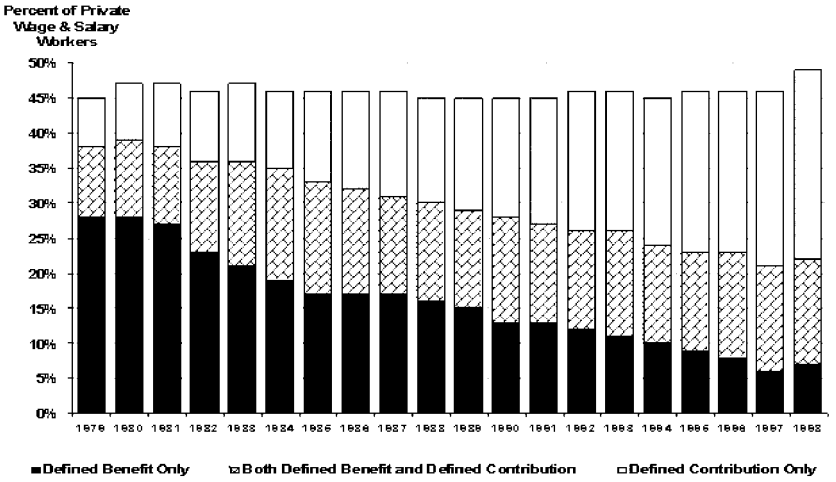
The percentage of the workforce participating in either a defined benefit or defined contribution pension plan has not changed appreciably in the last 20 years. But the mix has changed. The percentage of the private sector workforce that has a defined benefit plan declined from 38 percent in 1980 to 22 percent in 1998. In 1980, over 80 percent of workers with a pension plan had a defined benefit plan. By 1998, that percentage had dropped to less than 50 percent. In 1980, about two-thirds of workers who had a defined benefit plan had no other employer-sponsored plan; by 1998, that ratio had reversed with only about one-third having no other plan. As defined benefit plans declined, 401(k) plans, a type of defined contribution plan, grew. Introduced in the early 1980s, the number of 401(k) plans grew from 17,000 in 1984 to over 300,000 in 1998.

Private Workforce Participation in Defined Benefit Plans
1975–1998



SOURCE: U.S. Department of Labor, Pension Welfare & Benefits Administration, Abstract of 1998 Form 5500 Annual Reports, Winter 2001–2002

Pension Participation Rates
1979–1998



SOURCE: U.S. Department of Labor, Pension Welfare & Benefits Administration, Abstract of 1998 Form 5500 Annual Reports, Winter 2001–2002

Reasons for the Decline of Defined Benefit Plans

A number of factors have caused the shift away from defined benefit plans since the mid-1980s. Employment has shifted from the unionized, large manufacturing sector companies where defined benefit plans were common to the non-manufacturing sector with smaller employers where defined contribution plans predominate. Workers placed less value on defined benefit plans, and employer attitudes towards pensions changed from one of paternalism to one of worker self-reliance.

A new type of plan, the 401(k) plan, became available in the mid-1980s, and employers now had another option. Younger, more mobile workers preferred the portability and investment control offered by these 401(k) plans.

Changes to pension and tax laws have increased the complexity and costs of administering defined benefit plans. Companies with defined benefit plans found themselves increasingly competing, domestically and globally, with companies that did not offer any plan or offered only a defined contribution plan. Funding of defined contribution plans, unlike funding of defined benefit plans, is more predictable and easier to control.

The only type of defined benefit plan that is increasing in number is the cash balance plan. Cash balance plans typically credit a percentage of a worker's salary plus interest each year to a participant's cash balance account. At retirement, the participant generally has a choice between taking a lump sum or an annuity. Because there is a nominal account with a growing balance, the plan looks like a 401(k) account. A growing number of employers with defined benefit plans are shifting to cash balance plans rather than abandoning defined benefit plans altogether.

Conclusion

Mr. Chairman, I appreciate the opportunity to address the Subcommittee. Your consideration of the future of defined benefit plans is important to this Nation's long-term retirement outlook. Defined benefit plans remain a vital component of our retirement system.

My staff and I would be happy to provide any information that the Subcommittee might need in the future as you study defined benefit plans. I'd be happy to answer any questions from the Subcommittee.

Chairman HOUGHTON. Thanks very much. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Thank you for your testimony. I appreciate it. Given the diminishing role that defined benefit plans will play in workers' lives and the importance of a predictable and guaranteed base of income in retirement, how important do you believe it is to ensure that Social Security, which is a defined benefit system, remain that rather than being partially privatized.

Mr. KANDARIAN. It is a three-legged stool of Social Security, a private pension of some sort, and personal savings. Each is critical for everyone's retirement. Social Security is the first leg on that stool.

I certainly support the President's view on Social Security reform. I think the long-term gains people can realize if properly investing a portion of their monies makes a lot of sense. It is a voluntary system that he is proposing. I certainly think it is a wise idea.

Mr. COYNE. So, you don't think that is putting in jeopardy any kind of stability as a defined benefit plan if Social Security is partially privatized?

Mr. KANDARIAN. Social Security is not my area of responsibility or expertise. Certainly from what I have read and studied to date, the demographics are such that there will be fewer and fewer active workers compared to the number of retirees and something has to be done in the long term to make the system viable.

Certainly the kinds of returns that have been realized within the system to date are problematic for the long-term health of the system. So, again, I do support strongly the President's view of allowing people to voluntarily invest part of their monies in specified accounts.

Mr. COYNE. In your testimony you pointed out about the steady decline in the number of defined benefit plans. I wonder if you would elaborate further on what you think the reason for these declines have been.

Mr. KANDARIAN. For the overall system?

Mr. COYNE. Yes.

Mr. KANDARIAN. Well, the biggest decline in terms of the numbers, again, are the smaller companies, the smaller plans, under 100 participants. In terms of what we can do about that, there is legislation that has actually passed the House, it is H.R. 3762, the Pension Security Act, which contains helpful provisions was originally voted on last year but was dropped for reasons of germaneness.

These non-controversial provisions which reduce premiums for smaller firms and especially for first time employers in the system, would go a long way, we believe, toward making these kinds of plans more attractive and palatable. So, that is one way we can perhaps turn around that piece of the system.

In terms of the larger companies, it is a difficult question. You take a look at companies like Microsoft or Wal-Mart and other very large employers that do not have defined benefit plans. You have to ask yourself why does that segment of the economy choose not to enter the system.

I have not talked to them directly and I don't know first hand specifically as to those companies I mentioned, but overall, there are issues, I think, in terms of where our economy has gone, the level of competition businesses face today, the interest and, in fact, I would say the need for businesses to remain as flexible as possible financially. For some large companies that are not in the system, their concern is that if they come into the system, if it is too difficult in terms of how much they have to put into the plan at any one point, especially during a recession or a down year with very aggressive both domestic and foreign competition that may not have a defined benefit plan, they are at a competitive disadvantage. So, I think that is a factor that I am not certain that can be totally addressed legislatively. I think that is an issue of competition in the business world.

Mr. COYNE. In your testimony you pointed out that the PBGC is financially secure at this time. What do you see as the biggest threat to the security of the PBGC in the short and the long term?

Mr. KANDARIAN. In the short run there are a couple of industries in particular that have highly underfunded plans. They have some troubled companies in those industries. Specifically, the steel industry has about $9 billion in underfunding. About half of that underfunding is in companies that are currently in chapter 11. Now being in chapter 11 alone doesn't mean that we take over the plan, but certainly it raises the probability that some of those plans may come into us.

The airline industry has gone from being about $3 billion underfunded in the year 2000 to $11 billion in the year 2001. Certainly just reading the business press, there are a number of companies there that are seeking loan guarantees and have expressed concern about their current financial status.

So, those are the kinds of things we are looking at in the short run. The impact in terms of what that does to our current surplus is difficult to know and certainly I don't want to speculate about specific companies not remaining in business. It wouldn't be a wise thing for me to be doing as a Federal government official.

Overall, these industries are troubled, have large underfunding, and depending upon what happens to these businesses, our surplus could diminish greatly and could actually turn into a deficit.

Mr. COYNE. Do you have any additional measures that you think ought to be taken to minimize any further financial threat to PBGC? Do you have additional recommendations?

Mr. KANDARIAN. In the case of Republic Steel, as I mentioned, we moved to terminate that plan prior to the point in time when the company would have terminated that plan. That avoided taking in what is called shutdown types of benefits. That reduced the liability to PBGC.

There is about $2.7 billion in shutdown liabilities in the steel system today. Over $1 billion of that is in bankrupt companies. So, that would be one aspect of the liabilities we face that we have some control over and which on a case-by-case basis we have to consider under the existing law.

Mr. COYNE. Thank you very much.

Chairman HOUGHTON. Let me just ask you a quick question before I turn it over to Ms. Dunn. This is all opinion, but if you take a look at the trends here, you are going to be under water.

Mr. KANDARIAN. Mr. Chairman, I'm sorry. I don't hear very well. Could you speak a little closer to the microphone?

Chairman HOUGHTON. Yes. You are going to be under water if these trends continue. Also, when you talk about the steel industry, if I understand it, half of the steel companies are now in or near bankruptcy. So, what happens at that point?

Mr. KANDARIAN. To the Agency?

Chairman HOUGHTON. Yes. I mean this thing turned in 1995 for a variety of different reasons. One was the increase in the premium. What happens here?

Mr. KANDARIAN. Historically, from inception to today, 38 percent of the claims against our system have come from the steel industry. The workers in the steel industry represent about 2 percent of the participants in our insurance system. So, you see the problem right there.

Chairman HOUGHTON. Right.

Mr. KANDARIAN. Airlines represent over 20 percent of the whole, of the 100 percent. So, those two alone—only

Chairman HOUGHTON. How about the retail? You said the retail was in trouble, too.

Mr. KANDARIAN. Retail, I wouldn't say as an industry, but as is public knowledge, K-Mart is in chapter 11 and they are a very large company. So, that is of concern to us. Steel and the airlines

are the two big ones in the near term that could be very troublesome in terms of our financial health.

Now, we have very little control other than on issues such as shutdown costs and on things called follow-on plans, which means the company goes into chapter 11, tries to reorganize, terminates their pension plan because they can't support it, and then they want to have a new plan on the way back out of bankruptcy.

We have some say on whether or not they can have another defined benefit plan immediately. Those are the only real substantive issues that we can get into in terms of limiting the liability side of our balance sheet.

Other signs in terms of our financial health are assets. A question there might be how might you better invest your monies. There are current constraints in the law and current constraints in terms of Board policy, I think, in many cases for many good reasons. We are conservatively invested, so I think we are fine in that sense. We certainly don't get very high returns, let us say, compared to some pension funds because we must be conservative.

Chairman HOUGHTON. Well, thank you very much. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. I was glad to hear your comments on the ideas that came out of the Joint Committee on Social Security. I simply want to add a couple of points to that because I know that you work in this area. My particular interest is in making sure that women moving into retirement are able to have some sense of peace of mind that their pension is going to be there when they get there.

Therefore, Social Security becomes hugely important to them as one of those three legs you talked about. In 75 percent of the cases, women live longer than men. Currently, Social Security is paying about 2 percent in my district, under a 2-percent return on the dollars that are put in on their behalf through their working lives.

I think we have an opportunity, if we do it right, to make sure that women are even more secure moving into retirement. I see, for example, one of the pieces of legislation out there that we used to call Archer-Schotts, now the Shaw bill, that creates the benefit coming from Social Security as a floor to what women will collect once they go into retirement.

So, I was really happy for you to mention that. I simply want to urge you to look at all the possibilities that would come from this because many of us are going to begin formulating ideas next year to put into legislation that will help women out.

You talked about a premium increase. Tell me how this all works. If you do slide down, down, down, go into deficit, can you continue to operate in a deficit position?

Mr. KANDARIAN. Actually, we can operate in a deficit position and did from 1974 to 1995. The reason we are able to do that is that our assets are liquid securities, meaning public stocks, and U.S. Treasury bonds, which represent about 60 percent of our assets. So, we have money today.

When you look at our position in terms of why we are in deficits—because obviously, our liabilities are greater than our assets. Our assets are on hand today, while our liabilities are over the lives of all these retirees who are now in our system. So, we don't run out of money when we go into deficit. It simply means, on an

actuarial basis, if nothing else changed, we would eventually in the out-years run out of money.

So, how do you get out of deficit? Well, the first thing you hope happens is that current premiums eventually outpace any new failures that come into the system; the economy turns around, fewer failures.

You hope that the asset side of our balance sheet grows, especially the stock portfolio that we own, which is about 35 to 40 percent of our assets. There are other actuarial assumptions that can impact our responsibilities which might make them actually decline.

So, I would say the last thing I would like to do in the whole spectrum of things to do is raise premiums. The reason I feel that way is that from inception in 1974 to today premiums have gone up 19-fold. If you adjust for inflation, they have gone up 5.4 times the rate of inflation.

If we are trying to encourage defined benefit plans, I think it would be counterproductive to talk, at least initially, in terms of a premium increase when premiums have already been increased significantly from the start of PBGC's history.

Ms. DUNN. Is there any further answer that we need to be paying attention to now considering what is happening in the steel industry and other industries to deplete your funds?

Mr. KANDARIAN. I don't think there is much we can do other than wait and see how it shakes out. When we get to that point, if we slide into a deficit position, we will have to see where we stand and see what kinds of responses make sense.

Ms. DUNN. Do you have the ability to do this is through regulations or must there be some sort of legislation that helps you out?

Mr. KANDARIAN. On the premium side, we actually have regulatory authority but it has never been exercised, and I wouldn't propose exercising it. It has always been done by Congress.

Ms. DUNN. Thank you. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Ms. Dunn. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. This is a great hearing. I have known the preceding two administrators of PBGC and I don't know, this is the first opportunity I have had to have the testimony and the presentation and Congressional focus on what you do and to how pensions work. I think this is a very important undertaking.

For example, I don't think we understand defined benefit plans very well. To suggest that you could do better for women who outlive men on average by 7 years and assure them a guaranteed annuity payment, payable every month for as long as they live, you can't do better than that.

That is why Social Security works so well and that is why defined benefit plans work so well. We need to make certain that we certainly guarantee the pension benefits already out there and try and create a market where we might elicit new interest. That is why I appreciate your observation on premium increases. I think we don't want to go there unless we absolutely have to.

The time we passed the reforms in 1995 or whenever it was, we figured we fixed the solvency thing once and for all, especially with

the market run up. Although things have leveled out a bit since then.

Your predecessor, David Strauss, gleaned from his statutory authority the responsibility to be the advocate in the Administration for defined benefit plans. How do you view your responsibilities in this way?

Mr. KANDARIAN. I view my responsibilities as the protector of the defined benefit plan system. In terms of advocacy, to a degree I want to be an advocate of retirement security, which includes defined benefit plans, but certainly coming from the business community, I realize that for some companies it is the most appropriate and best vehicle and for some other companies it may not be the most appropriate and best vehicle.

Congress, in its wisdom, passed legislation that enables companies to choose among different kinds of voluntary private pensions. Certainly, I am very supportive of defined benefit plans, but I wouldn't suppose to tell all companies that it is the appropriate vehicle for all of them.

Mr. POMEROY. I understand. That isn't what I was meaning in indicating that the PBGC position should be the champion of pensions. I think what I mean is making certain the fund is solvent, making certain that the concerns about business relative to premium and regulation are listened closely to and responded to, if at all possible, without jeopardizing the guarantees.

Mr. KANDARIAN. Absolutely. When I came to Washington I took it upon myself to introduce myself, because I am new to town, to many of the stakeholders and constituent groups, including those representing labor, representing business interests, people on the Hill, including yourself.

Mr. POMEROY. I appreciate that.

Mr. KANDARIAN. My interest was to just say, here I am, I am now the Executive Director. Any concerns, please feel free to pick up the phone and call me. That is an open invitation to anyone in the system.

Mr. POMEROY. Well, I think you have demonstrated in your testimony today that you have really ramped up very, very quickly in terms of getting a grasp of the responsibilities of your office.

I also would like to note that the activities of your staff are really quite phenomenal. The number of plans that they are administering, the sheer volume of checks they are cutting every month, the retirement security of citizens, there is a very strong record of productivity in their performance.

Mr. KANDARIAN. I can't say enough about the staff and their professionalism at PBGC. It has been very welcome for me to come into an organization as well run as it is. We are trying to even go further in the future on customer service. We are trying to introduce a lot of new technology to make things much more interactive with workers who have pensions from us, so they can see things online, just like you would, maybe, with the Fidelitys on the world where you get on-line and do things yourself and not have to wait for someone to pick up the phone.

So, one of my initiatives on the administrative side is to create a new position at PBGC called Chief Technology Officer that reports directly to me so that over the next few years we will be in

a position to have the most current technology available in the marketplace for all the stakeholders, whether it be workers or companies, to interact with us.

Mr. POMEROY. That is excellent. A final point, I think we have a lot to learn about the role of annuities in retirement securities. This is not at all in reference to the Social Security debate. We will have plenty of that another time. I mean people retiring, even from, for example, a hybrid plan, a cash balance plan, and not exercising the annuity option and instead taking a lump sum determination.

I think as you evaluate the studies of the performance of the plans and information that you might derive relative to how the annuity income stream matches the retirement income needs of the pensioners, it would be helpful information. Maybe we will have some cross transference in terms of Congress understanding that we need to do more to incent the American public to move toward an annuity option and they look at management of their own retirement assets.

Mr. KANDARIAN. We would be happy to work with you on that. One observation on our side is that putting aside plans that come into us, just plans in the marketplace, most people, when they leave, do take lump sums if they have that option. About 25 percent of participants have that option and a lot of them take that option. It is hard for me to be too judgmental about their lives and their needs, but in terms of retirement security it is problematic.

Mr. POMEROY. A final point, just an observation on that point. You know, you have asked them, as we have converted to other types of plans, the American worker to take an awful lot of responsibility, savings at adequate rates, investing in appropriate ways. The one we are really just starting to understand, the issue we have to deal with, the level of information people have to match their finite assets with their unknown life expectancy.

Mr. KANDARIAN. Right.

Mr. POMEROY. I think that people are making decisions, but that doesn't mean they have been given any information about how best to make those decisions. I believe annuities have a much greater role to play in the future. I want to work with you as we learn about marketplace activity that might shed light on these issues.

Mr. KANDARIAN. We would be happy to do so.

Mr. POMEROY. Thank you very much, Director.

Chairman HOUGHTON. Thank you. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman. Thank you for being here. It is good to see you. Tell me, do you support the PBGC related small business changes included in the Pension Security Act that passed the House and is waiting action in the Senate today?

Mr. KANDARIAN. H.R. 3762, the Pension Security Act that passed in April?

Mr. JOHNSON. Yes.

Mr. KANDARIAN. Yes, we do.

Mr. JOHNSON. You do?

Mr. KANDARIAN. Yes.

Mr. JOHNSON. How is that going to affect you one way or the other?

Mr. KANDARIAN. We think it would enable some of the smaller employers to find our system more attractive than they do today by lowering the initial amounts of the premiums they pay and just making it less costly as they first get introduced into the system. Now they may find some of those barriers just too great in terms of entering the system.

Mr. JOHNSON. So, you think that some of the small businesses might invoke a pension plan that would come under your purview?

Mr. KANDARIAN. We hope so. We wouldn't know until, obviously, the legislation passes and we see how the marketplace reacts. It is the part of the system that has seen the greatest decline in numbers of plans and participants, well plans certainly. So, we would like to try to offer something to attract them into the system and make it more palatable at the start.

Mr. JOHNSON. I agree with you, but how do we get people to participate in those kind of plans and companies to offer them more effectively?

Mr. KANDARIAN. I think your question almost answers itself in the sense that the workers have to really value this benefit for the employer to say, "I will take this obligation, this liability." It is a different kind of obligation or liability than the 401(k) plan which is much more flexible for an employer who in a bad year doesn't have to fund it.

That same kind of flexibility doesn't exist necessarily in a defined benefit plan. There could be minimum funding requirements. So, for an employer to say, "I will trade off that risk for some reward," the question is what is the reward? Presumably, the reward is to have a better, more loyal workforce. That means the workers have to understand and appreciate that pension. If they don't, then it is less likely the employer will take on such a plan.

Mr. JOHNSON. Well, 401(k)s are kind of questionable at the end of your employment period. I think maybe people are finally realizing defined benefit or defined payment plans are something they need.

Do you have any suggestions for an appropriate replacement for the 30-year Treasury bond as the interest rate for pension calculations and do you think there should be one number used for all purposes or should there be different numbers for different fund planning?

Mr. KANDARIAN. We are actually in discussions right now with our colleagues at the Treasury Department and Labor Department on this issue and haven't yet come up with a position. It is certainly an issue that needs to be addressed. I hope the issue is addressed this year.

Mr. JOHNSON. Do you think we need legislation to implement whatever your decision turns out to be?

Mr. KANDARIAN. My understanding is that it would require legislation, yes.

Mr. JOHNSON. Thank you. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much. Mrs. Thurman, you are all set? Okay. Let me ask you a question. Mr. Gutknecht was here before and he talked about the vagaries and the downsides of the cash balance program. You have said that you think that maybe the cash balance program is something which is

going to be the savior of the system. Also, I have a question. So that is really one question.

The other is that the Pension Guaranty Benefit Corp. was established in 1974 to protect defined benefit, but not defined contribution plans. So, how does the cash balance fit into that? Maybe you can handle both of those questions.

Mr. KANDARIAN. A cash balance plan is a form of a defined benefit plan. It is just one design of a defined benefit plan, therefore, it is covered by ERISA guarantees. Of course, defined contribution plans are not. Did you want me to comment further about cash balance plans?

Chairman HOUGHTON. Yes, go on. Please elaborate on this.

Mr. KANDARIAN. As to cash balance plans, I think the Congressman correctly pointed out some problems associated with conversions which is different from a new cash balance plan where there is no defined benefit plan to begin with. I think the latter, that is a new cash balance plan, is less controversial and I am not sure I have heard very much disagreement in the community about the desirability of those plans.

Certainly the conversions have some issues that are difficult and thorny and must be looked at. I know that the Treasury Department has some regulations that they are looking at and proposing soon and actually have, I think, a draft reg out right now on some notice provisions. So, again, under ERISA, this whole area is divided up among the three different places in the Administration, Labor Department, PWBA, Treasury Department, and the PBGC. The element that the Congressman was referring to is really being addressed by the Treasury Department today.

Mr. JOHNSON. My impression was that he was a little concerned about the long term of the cash balance programs because there wasn't enough time. He suggested a 90-day period where people could turn around and also he was worried about the vesting provisions. Do you worry about those things also in the cash balance plans?

Mr. KANDARIAN. Again, those are regulations that the Treasury Department is looking at. I think I would rather, at this point, pass on giving a specific viewpoint until I have more time to see what they are proposing and work with them.

Chairman HOUGHTON. I have only one final question and that is always looking over the next hill and taking a look at what PBGC might be in 20 or 30 years. We are going to have big changes in our economy, particularly from abroad. Do you see any fundamental changes in the charter or the approach that you have to the plans which you are now backing up?

Mr. KANDARIAN. I think my biggest long-term concern, and I am talking about 20 or 30 years out, would be maybe the corollary to Social Security, which is the demographics. So, if for example the strongest companies eventually drop out of the system for whatever reason, and if they are fully funded they can terminate their plans by buying an annuity in the private markets and simply not have a defined benefit plan going forward and therefore not be paying premiums to PBGC.

So, if that were to occur by the strong companies that could buy those annuities in the marketplace because they are fully funded

and what you had left over were the companies that had highly underfunded plans, and perhaps the correlation there is that they be weaker companies, then you would have a much smaller base upon which to, if necessary, raise premiums or somehow tap into to support the insurance system.

So, I guess the upshot of that is that we want to make this system, which is a voluntary system, as palatable, as attractive, and as good as possible for those strong companies to stay in the system. If they don't, long term, I think we have a big problem.

Chairman HOUGHTON. Well, I certainly agree with you. Thank you very much for your testimony and for your willingness to share your knowledge with us. We hope to get you back again. Thank you so much.

Mr. KANDARIAN. Thank you, Mr. Chairman.

Chairman HOUGHTON. We are going to call our third panel. Sorry to be so long here, but we have Jack VanDerhei, who is an Employee Benefit Research Institute (EBRI) Fellow. We have Ron Gebhardtsbauer, Senior Pension Fellow of the American Academy of Actuaries; Karen Friedman, Director of Policy Strategies, Pension Rights Center; Dr. Jonathan Skinner who is a Professor in the Department of Economics at Dartmouth; Scott Miller, President-elect of the American Society of Pension Actuaries (ASPA); and Mark Beilke who is the Director of Employee Benefits Research at Milliman USA in Wisconsin, he is working on behalf of the American Benefits Council (ABC); and also Christopher W. O'Flinn, Chairman of the ERISA Industry Committee (ERIC), and Vice President of the Corporate Human Resources of AT&T.

Now, if this panel can't answer our questions, no panel can. So, we are honored to have this lineup of distinguished people, with your basic knowledge. I would ask Mr. VanDerhei to begin his testimony.

STATEMENT OF JACK VANDERHEI, FACULTY MEMBER, SCHOOL OF BUSINESS MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PENNSYLVANIA, AND DIRECTOR, FELLOWS PROGRAM, EMPLOYEE BENEFIT RESEARCH INSTITUTE, PRESENTING STATEMENT OF DALLAS L. SALISBURY, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Dr. VANDERHEI. Mr. Chairman and Members of the Subcommittee, I am Jack VanDerhei, a Faculty Member at Temple University's Fox School of Business Management in Philadelphia and Research Director of the EBRI Fellows Program. I am here to submit the testimony of Dallas Salisbury, President and chief executive officer of the Employee Benefit Research Institute. Unfortunately, he could not be here today due to scheduling conflict after the hearing was rescheduled. Accordingly, I ask that his testimony be submitted for the record.

In the few minutes I have here I would like to highlight part of Mr. Salisbury's testimony and draw attention to some of EBRI's research on retirement security. As I am sure others have mentioned, and I will not belabor the point, the trend in U.S. retirement plans has moved away from the so-called traditional defined benefit pension plans and toward defined contribution retirement plans such as the 401(k).

Mr. Salisbury makes the point that this ignores how defined benefit plans have also changed. Evidence shows that increasingly they pay individuals lump sum distributions rather than annuities. Estimates suggest that the vast majority of defined benefit plan participants who leave an employer with less than 10 years of service take a lump sum distribution;

That a significant percentage of defined benefit plans now offer lump sum distributions on retirement and that nearly all the cash balance plans offer lump sum distributions. This fundamentally affects the way in which a defined benefit plan contributes to retirement security.

By way of example, Mr. Salisbury likes to cite his father's defined benefit pension plan which began paying him a monthly annuity in 1978. Today, that check represents a very important contribution to his parents' retirement security, largely because they have lived years longer than they had expected to live and have spent all the money they saved.

The greatest virtue of an annuity is this protection against unexpected longevity. That is the only true form of retirement income security in Mr. Salisbury's opinion, a check that does not stop until one dies.

Our research underscores the point of this personal anecdote. According to projections I have simulated with Craig Copeland of EBRI, there will be a definite decrease in traditional defined benefit income and a corresponding increase in retirement income that will need to be managed by individuals themselves.

Our model is based on timed series of pension plan provisions including those changes necessitated by the Tax Reform Act 1986, as well as employee behavior observed for more than 11 million participants for more than 30,000 401(k) plans. We modeled expected future retirement income from private retirement plans for males and females born between 1936 and 1964, in other words, for those who would be between the ages of 38 and 66, and then determined how much of each groups retirement income is likely to be attributed to each of three components: First, defined benefit plans; second, individual account employer-sponsored plans. These include both defined contribution and cash balance plans. Thirdly is rollover to IRAs.

We found that for males the percentage of private retirement plan wealth provided by defined benefit plans will decrease from 39 percent for today's retirees to 26 percent for the 38 year olds. While for females in those age cohorts, they are expected to undergo a similar decrease from 50 percent to 37 percent.

The combination of defined contribution plans and cash balance plans perhaps surprisingly is expected to remain relatively constant, between 32 and 34 percent of private retirement plan wealth for both genders.

The component that is assumed to grow substantially is made up of rollover to IRAs. Under our baseline assumptions, males are expected to increase the percentage of retirement wealth attributable to this component from 28 percent for today's retirees to 40 percent for 38 year olds when they retire.

Females are expected to have a similar increase from 18 percent to 31 percent. It should be noted that these projections are based

on the assumption that the current scenario does not change. For example, defined benefit plans do not continue to decline in prominence. If the trends we have seen in the last two decades continue, however, the shifts will be even more in favor of individual account plans that are unlikely to result in annuitization.

The simulator results have very important implications for future retirees. First, individuals, rather than plan sponsors, will have to shoulder the risk of investment losses while they manage their retirement assets.

Second, retirees increasingly will need to decide what to do with their lump sum distributions from all sources. This applies not just to 401(k)s or IRAs, but also to the non-Social Security income they are receiving from a defined benefit plan in the form of a lump sum.

For many retirees, their financial security will depend on buying an annuity from an insurance company or exceedingly careful money management to avoid outliving their assets. The point here is that the percentage of private retirement income paid in the form of annuity is likely to decrease substantially.

Public policy with respect to future retirement security should not be based exclusively on a debate about defined benefit or defined contribution plan type. The future debate must also include worker education on savings, investing, longevity, retiree health, long-term care and what choices individuals can make to avoid running out of money before they die.

That concludes my statement. I will be happy to answer questions at your convenience. Thank you, Mr. Chairman.

[The prepared statement of Mr. Salisbury follows:]

Statement of Dallas L. Salisbury, President and Chief Executive Officer, Employee Benefit Research Institute*

Mr. Chairman and members of the Committee, it is a pleasure to appear before you today to discuss retirement security and defined benefit pension plans. I am Dallas Salisbury, President and CEO of the Employee Benefit Research Institute. EBRI [1] has been undertaking research and education on employee benefit issues since its founding in 1978. EBRI does not lobby for or against specific proposals, instead our mission is to provide data that will assist others in assessing trends and in making policy decisions.

Since my full submission will be included in the hearing record, I will provide a brief summary of points for your consideration:

1. Since I joined the U.S. Department of Labor in 1975 to assist in the implementation of the Employee Retirement Income Security Act of 1974 (ERISA), defined benefit pension plans have changed a great deal.
2. Then, nearly all paid benefits in the form of annuities for most individuals when they reached normal retirement age. Essentially all of the nation's largest employers had a defined benefit plan and a thrift-saving or profit-sharing plan, and multi-employer trusts and public employers had defined benefit plans.
3. Today, largely as a result of decisions made by government, defined benefit pension plans pay more individuals lump-sum distributions than annuities, supplemented by defined contribution plans to which the employer contributes. Many of the largest new-economy employers that never had a defined benefit plan, and are now among our largest employers, rely exclusively on defined contribution plans. Most multi-employer trusts and public employers sponsor both defined benefit and defined contribution plans.

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*EBRI is a private, nonprofit, nonpartisan public policy research organization based in Washington, DC. Founded in 1978, its mission is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI does not lobby and does not take positions on legislative proposals.

4. Data from the Federal Reserve Survey of Consumer Finance documents the trend toward plan change.[i] Of all families reporting at least one worker with some type of pension coverage, the portion of those families with at least one worker participating in a defined contribution plan only was 57% in 1998, compared with 38% in 1992, while families with at least one worker participating declined from 40% to 21% between 1992 and 1998, while workers with both stayed steady at 22% in both 1992 and 1998. The best available estimates suggest that the vast majority of defined benefit plan participants who leave an employer with less than 10 years of service take a lump-sum distribution; that over half of all defined benefit plans now offer a lump-sum distribution at retirement; and that nearly all of the over 500 individual account defined benefit plans ("cash-balance" plans) offer lump-sum distributions.
5. I note this trend toward defined benefit plans paying lump-sum distributions because it fundamentally affects the way in which a defined benefit plan contributes to retirement security, yet too many articles and analyses still assume/suggest that all defined benefit plans pay annuities upon retirement, thus shielding retirees from the need to make investment, longevity, rate of spending, and other decisions required of those who are paid lump-sum distributions. The year 2002 finds far less difference between the amount of retirement security provided by the defined benefit and defined contribution plan systems than existed in 1974.
6. Public policy change joined with demographics and economics to bring these two plan types closer together. The primary difference between defined benefit and defined contribution plans to this day is the fact that private employers make the funding contributions to defined benefit plans, and in the event of adverse investment performance must contribute more in order to pay the promised accrued benefit, while both employers and workers generally contribute to private defined contribution plans, and the worker alone bears the burden, or gains the fruits, of bad or good investment performance.
7. The federal government was one of the first major employers to drastically reduce the generosity of its defined benefit pension plan, while adding a defined contribution plan (1984), but many others in both the public and private sectors have followed suit. The primary reasons it was done: a desire to reduce cost and future funding liabilities; a desire to reduce the golden handcuffs that make it difficult for a worker to change jobs; a desire to allow greater fund accumulation for shorter service workers; a desire to provide a program that workers would better understand and be more likely to appreciate.
8. Rules and regulations related to defined benefit plans are extensive and complex, as is the administration of the plans, as indicated by the recent Department of Labor report. That report underlined the shift of plans to the payment of lump-sum distributions, and the complexity of making the benefit payment calculations. The worker tradeoff for this complexity, and the potential for errors, is that the employer typically makes all contributions to the plan and the participant is protected (up to the PBGC guaranty limit) against investment "losses" as well as an entire array of potential deviations from actuarial assumptions.
9. Defined benefit plans (with the exception of a few contributory plans) are full participation plans, as workers do not make a choice on whether or not to participate. For workers that may not be inclined to contribute to a 401(k) plan (particularly the lowest paid workers), this may make a defined benefit plan preferable to a 401(k) plan (although some 401(k) plans may provide nonelective contributions whether or not the employee contributes). Were that worker to stay for a full career (a low probability), the benefit value/account balance would grow to a level amounting to a meaningful contribution to retirement security. Were the worker to leave after a few years of employment, either a defined benefit plan or a defined contribution plan would provide a small lump-sum distribution that likely would be spent.
10. Large employers that had defined benefit plans in 1974, and are still in business, in most cases still have them. The design changes to lump sums and cash balance have allowed them to compete with defined contribution plans for worker understanding and appreciation. Proposals such as allowing pre-tax worker contributions to defined benefit plans would further

[i] See Craig Copeland and Jack VanDerhei, Personal Account Retirement Plans: An Analysis of the Survey of Consumer Finances, *EBRI Issue Brief* No. 223 (July 2000).

erase the differences between the plan types, and might lead to an increase in the sponsorship of defined benefit plans. Were benefits paid in lump-sum form, however, this would likely have no favorable impact on retirement security (once the worker retires) relative to a defined contribution plan.

11. My father's defined benefit pension plan began paying him a monthly annuity in 1978. Today, that check represents a very important contribution to my parents' retirement security. Why? Largely because he and my mother have lived years longer than they planned or expected to, and they have spent all the money they saved. The greatest virtue of an annuity is this protection against unexpected longevity. That is the only true form of retirement income security: a check that does not stop until one dies. It is no longer the case that all defined benefit plan retirees choose to be paid in annuity form, and few defined contribution participants do so. Future retirement security should no longer be based on a debate about defined benefit or defined contribution, as that is no longer the central issue when both plan types paying lump-sum distributions at job change and retirement. The future debate must be about worker education on savings, investing, longevity, retiree health, long-term care, and what choices individuals can make to avoid running out of money before they die.

Introduction

A review of the state of defined benefit pensions must begin with a clear understanding of what a "pension plan" is. While this sounds simple, it is done because the "legal" meaning has clearly changed over the past 28 years.[ii] Today, the term is used to describe any employer or government-sponsored capital accumulation program that has a stated purpose of providing funds for retirement. Defined benefit, defined contribution, annuity payment or lump-sum distribution form, all are within the new definition.

ERISA expansion of the definition of pension *plan* to include capital accumulation plans with lump-sum distributions at "termination of covered employment," as opposed to "at or near retirement," actually serves to clearly highlight the "State of Pensions" in the United States. Both the public and private sector have moved in the direction of sponsoring fewer plans that only pay benefits "at or near retirement", and have created more and more plans which pay at "termination of covered employment". The result has been dramatic changes in defined benefit pension plans—those that promise a fixed accrual and a determinable benefit without worker investment risk—including the development of defined benefit individual account plans ("cash-balance" plans) and growth in the number of defined contribution plans—those that promise payment of funds contributed (once the employee is vested), adjusted for investment earnings, but promise no fixed benefit, as the worker holds investment risk.

I do not provide a normative assessment of whether these trends are good or bad for employers, unions, individuals, or public policy. They are what they are.

1996 data from the U.S. Bureau of the Census combined all plan types under the single heading of "pension," as do the data from the Federal Reserve. The data show the impact of a maturing pension system, with the divergence of net flows and net contributions. Net flows are a measure of new contributions, plus all investment earnings, less benefit payments. Net contributions are a measure of benefit payments less new contributions. The fact that net contributions are negative, while net flows are positive, underlines the primary virtue of advance funding, compound interest, and investment earnings.

For the individual worker, the move to more lump-sum distributions from defined benefit and defined contribution plans suggests a number of needs:

- A need for basic financial literacy education.

[ii] The Employee Retirement Income Security Act of 1974 (ERISA) states: "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances, such plan, fund, or program—'(A) provides retirement income to employees, or results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan' (emphasis added). This represented an expansion in concept from the first full version of the legislative proposal, H.R. 2, which limited plans to those which "for the purpose of providing for its participants or their beneficiaries, by the purchase of insurance or annuity contracts or otherwise, retirement benefits, and includes any deferred profit-sharing plan which provides benefits at or near retirement."[ii] (emphasis added) H.R. 2 was closer to the traditional dictionary definition of a pension: "a retirement or disability allowance" (emphasis added).

- A need for understanding saving represents a tradeoff in lifestyle today in order to have money to live on tomorrow.
- A need for understanding investing, fees, returns net of fees, etc.
- A need for evaluation of how important the job-related benefits are, and the degree to which they may determine happiness for a lifetime.

What is the Pension Landscape Today?

Congress acted in 1983 to change the pension system for federal civilian employees. Prior to 1984, the only federal retirement plan was a final pay defined benefit plan. For those hired after the 1983 act, a new reduced defined benefit plan was accompanied by a generous 401(k)-type plan. Those already working had the option of remaining in the old plan or shifting to the new plans. Congress had also acted in 1978 to add two new sections to the Internal Revenue Code, 125 and 401(k). Proposed regulations in 1981 eventually led to a massive transition of traditional profit-sharing plans into 401(k) plans, which meant that the employee could contribute pre-tax dollars assuming the employer incorporated a 401(k) feature in their profit sharing plan. State and local governments, and non-profit organizations, had this type of opportunity in 457 and 403(b) plans. Legislation since 1986 has moved all these so-called "salary-reduction" plans closer together in design and rules, with nearly all employers now able to establish 401(k) plans. Recent years have seen debates in a number of states over proposals to either introduce expanded supplemental "salary reduction" plans, or to replace defined benefit plans with defined contribution plans. Demographic change, and economic competition, makes it likely that these debates, and trends, will continue.

The following table presents data from the U.S. Department of Labor on private employer pension plans in terms of number of plans. The trend lines are clear: defined benefit plans are on the decline and salary reduction plans are becoming the primary "pension" plans in the nation. The numbers on multi-employer plans reinforce the trend line of increasing use of supplemental and primary defined contribution programs.[iii, iv] Finally, the data hide the use of lump-sum distributions in defined benefit plans.

Number of Qualified Private Pension Plans 1975–2002

Year	Single-Employer Defined Benefit	Single-Employer Defined Contribution	Multi-employer Defined Benefit	Multi-employer Defined Contribution
1975	101,214	207,437	2,132	311
1985	167,911	461,158	2,261	805
1998	54,699	672,297	1,706	1,329
2002 est.	36,000	700,000	1,800	1,500

Sources: U.S. Department of Labor and author estimates.

As the number of plans has changed, so have the numbers of participants. Data from the Federal Reserve Survey of Consumer Finance document this trend through 1998.[iii] Considering all families reporting at least one worker with some type of pension coverage, the number of those families with at least one worker participating in a defined contribution plan only was 57% in 1998, compared with 38% in 1992, while the portion of families with at least one worker participating in defined benefit plans declined from 40% to 21%, while workers with both stayed steady at 22%.

Employer preferences for pensions now focus more on economic performance than retirement income security. Pensions are viewed favorably if they serve to:

- Improve corporate efficiency.[iv]
- Enhance morale.
- Keep channels for promotion open.
- Facilitate work-force reduction.
- Enhance employee identification with profit.

[iii] See Craig Copeland and Jack VanDerhei, "Personal Account Retirement Plans: An Analysis of the Survey of Consumer Finances," *EBRI Issue Brief* no. 223 (July 2000).

[iv] Jerry S. Rosenbloom and G. Victor Hallman, *Employee Benefit Planning*, third edition, Prentice-Hall, 1991.

[v] See Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?*, EBRI–ERF, 1989, chapter IV for a summary of research; Richard A. Ippolito, *Pensions, Econom-*

- Offer a most cost-effective and least administratively intense form of capital accumulation.
- Attract and hold capable employees.[v]

A senior corporate executive noted in 1998 that "not having benefits at some threshold level will repulse employees, but the mere presence of a more generous benefits package will not attract and retain employees."[vi] This view is explanatory of the movement in recent years to flexibility, and an effort to respond to environmental factors with program design. This includes:

- Respond to favorable tax laws that provide an incentive to provide a pension program.
- Respond to demands in labor negotiations.
- Respond to social and indirect government pressures.
- Respond to inherent advantages of group purchase/provision.
- Respond to shareholder desires and competition.

Developments in the retirement plan market represent a response to work-force patterns. There is now a large body of literature that uses government data to show that the workforce has always had high turnover and that few have spent 25 years or more with one employer. Not only is this true of the private sector, but it has been so for the public sector as well. Defined contribution plans and individual account defined benefit plans provide a career-average benefit, as noted above, which may serve to deliver more to most workers (due to relatively short service), than traditional defined benefit plans. For the employer, they provide a more certain cost, which can be more easily budgeted. A growing number of all plans provide lump-sum distributions, which are more popular with workers. They are portable, and once a lump-sum distribution is taken upon job termination they eliminate any employer-specific risks. Data from the Pension Benefit Guaranty Corporation underline the number of workers for whom this is a consideration.

Can We Return to 'The Way We Were'?

Writing prior to the enactment of ERISA, one leading actuary noted: "A defined benefit final-pay pension plan may be selected precisely because it is the only type of plan which permits the employer to design a pension formula that takes both sources of retirement income—Social Security and company benefits—into account. By doing so, a firm can provide higher paid employees a proportionately greater company pension. This compensates for the fact that these individuals receive a lower percentage of final earnings from Social Security."[vii] ERISA and subsequent legislation has limited the degree to which a plan sponsor can integrate a pension plan with Social Security (how much defined benefit can be offset), and funding and benefit limits have shifted much of what is done for high-income workers outside the qualified plan.

He continued: "Such a plan may also be necessary to reward an employee whose salary has increased rapidly or whose service was relatively short. Additionally, only a pension can reward past as well as future service and base the total benefit on final average pay. Finally, some companies believe that they are better able to assume investment risk . . ." Taking these in order, new funding and liability rules tied to plan termination insurance have all but ended the consideration of past service due to the liabilities it creates, and the difficulties the new funding limits place of setting aside funding. Employers and unions that believe they can better absorb risk have continued defined benefit plans, or moved to hybrid plans like the cash balance plan, rather than moving totally to defined contribution. The combination of the PBGC and tax-funding limits, however, make it unlikely that new defined benefit pension plans will be formed by either single employers or multi-employer groups. Whether this is good or bad, right or wrong, matters little in light of the overwhelming public policies that make it so.

The actuary concluded: "The corporate viewpoint on the defined benefit versus defined contribution issue is formed by various competing factors: (1) whether its fi-

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[v] See Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?*, EBRI–ERF, 1989, chapter IV for a summary of research; Richard A. Ippolito, *Pensions, Economics and Public Policy*, Pension Research Council, 1986; and Richard A. Ippolito, *Pension Plans and Employee Performance Evidence, Analysis, and Policy*, The University of Chicago Press, 1997.

[vi] See Charles G. Tharp, "Yes," in Dallas L. Salisbury, ed, *Do Employers/Employees Still Need Employee Benefits?,* EBRI–ERF, 1998, pp 11—13.

[vii] Robert B. Peters, *Defined Benefit and Defined Contribution* Plans: *A Corporate Perspective,* in Dallas L. Salisbury, ed., *Economic Survival in Retirement: Which Pension is for You?*, EBRI–ERF, 1982, pp 81—86.

nancial position can sustain the economic uncertainties posed by a defined benefit plan; (2) the extent to which competitive factors determine benefit levels and types; and (3) the corporation's perception of its responsibility to provide for employees' retirement and other financial needs." Fewer employers are willing to assume that they can financially sustain a plan as they may well be taken over or spun off tomorrow; the new economy employer creates constant pressure to change benefit programs by turning new hire and retention competition to current cash and short-term incentives, not a great pension 25 years hence; and increasingly employers view their primary obligation to be survival so that they can provide work, leaving post-work planning to the individual. Many employers and unions will view this last statement as overly harsh, but I view it increasingly as the reality. Because of these factors, defined benefit pensions are inherently problematic in this new world, as the sponsor issues relate to regulation, funding and liability, not to the simpler issue of portability.

What have changed are the regulatory environment, the workforce, world economics, technology, and feelings of employer and worker security. Taken together, they suggest that we will not return to the defined benefit design dominance of yesterday, regardless of the consequences for individual retiree economic security, and not even to the dominance of annuity payouts.

How 25 Years Has Changed Demands/Motivations [viii]

The government does influence action, and ERISA changed design drivers. The law went from no vesting minimum standard to immediate vesting in some cases; from asset use in a plan for building the firm to arms-length transactions; from clear "capital accumulation" versus "retirement plan" distinctions, to limited distinctions; from selective provision of lump-sums allowed to the 'all or none' requirement; from less government tax revenue from lump sums to greater government tax revenue from lump sums; from a retirement income focus to a cash portability focus; from a regulatory and tax incentive bias toward defined benefit plans to a strong regulatory and tax incentive bias toward defined contribution plans; from a clear emphasis on employer/union provision advantages to an increased focus on individual self determination and "retail delivery"; from a paternalistic assessment basis of social obligation and corporate identification to one of maximum satisfaction of the largest number of workers.

As one expert has put it, movement from "golden handcuffs" to an employee/employer contract of partnership, personal accountability, and self reliance moved the nation away from traditional defined benefit, employer-pay-all plans with their focus on encouraging an employee to remain with a single employer until "normal retirement age," and toward greater financial and psychological independence, and identification with the service firm versus the employer.[ix]

Plan design and recruitment action has moved from broad-based attraction to key employee attraction; from delivery of fast vested matches in short-term savings programs to vested matches for long-term savings programs; from delivery of final pay annuities to long-term workers to smaller accumulations for all workers and a focus on lump-sum distributions,[x], and from employers, unions and plans dealing with long-term risks, to avoiding long term risks (investment, inflation, mortality) and placing their burden on individuals and families.

Major employers and unions have always provided the pension coverage available today. Over 95 percent of participants are in large employer settings. Most large employers with 401(k) plans now use employer stock in the plans; some of the largest unions have negotiated stock ownership, or outright employee ownership. As one senior executive put it in 1998: "employee ownership allows the corporation to build partnership and a high performance work culture." [xi] As one executive notes:

> "While income security is an issue, it is increasingly being recognized that long-term security can best be achieved through personal develop-

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[viii] See Daniel M. Holland, *Private Pension Funds: Projected Growth*, National Bureau of Economic Research, 1966; *Private Pensions and the Public Interest*, American Enterprise Institute, 1970; and Norman B. Ture with Barbara A. Fields, *The Future of Private Pension Plans*, American Enterprise Institute, 1976, and Dallas L. Salisbury and Nora Super Jones, eds, *Pension Funding and Taxation: Implications for Tomorrow*, EBRI–ERF, 1994: and Dallas L. Salisbury, ed, *When Workers Call the Shots: Can They Achieve Retirement Security*, EBRI–ERF, 1995.

[ix] See Charles G. Tharp, "Yes," in Dallas L. Salisbury, ed, *Do Employers/Employees Still Need Employee Benefits?*, EBRI–ERF, 1998, pp 11—13.

[x] Steven G. Vernon, *Employee Benefits: Valuation, Analysis and Strategies,* John Wiley & Sons, Inc., 1993.

[xi] See Charles G. Tharp, "Yes", in Dallas L. Salisbury, ed, *Do Employers/Employees Still Need Employee Benefits?,* EBRI–ERF, 1998, pp 11—13.

> ment and professional growth. Ironically, the presence of high-cost '1950's, one size-fits-all benefits' may, in fact, be a precursor to job insecurity as cost-cutting measures may be necessary for an organization to carry this heavy burden." And, he continues: "There is a general question of whose responsibility it is to provide retirement income. There is increasing emphasis today on the notion that it is up to individuals to provide a greater portion of their own retirement security."

For the decades ahead such views are likely to dominate pension decision-making. Many of these views are now entering the debate over the future of Social Security—proposals by both the 2000 Republican and Democrat candidates for President for voluntary government sponsored individual accounts to supplement today's Social Security—and many of the same pressures and attitudes reviewed here can be found in that debate. In short, whatever one would like the pension world to be from a normative perspective, this descriptive review suggests that it will look more like the pension world of the 1990s than that of the 1950s. The individual will be king, and economic well being once one is no longer working will increasingly rest on what saving and consumption choices the individual made throughout his or her life. "Choose to Save" is taking on new meaning, as it will determine whether individuals can retire, or must work forever.

Once a worker retires, a retirement security debate over defined benefit versus defined contribution plans would only be relevant today if one plan type paid only annuities and the other only lump-sum distributions. As long as both plan types pay lump-sum distributions to all who have achieved small accruals, and as long as both plan types increasingly pay lump-sum distributions at retirement (retirees generally select a lump-sum when given a choice), the argument that one provides a greater promise of retirement security than the other, when both pay lump-sums, cannot be sustained.

My father's defined benefit pension plan began paying him a monthly annuity in 1978. Today, that check represents a very important contribution to my parents' retirement security. Why? Largely because he and my mother have lived years longer than they planned or expected to, and they have spent all the money they saved. The greatest virtue of an annuity is this protection against unexpected longevity. That is the only true form of retirement income security: a check that does not stop until one dies. It is no longer the case that all defined benefit plan retirees choose to be paid in annuity form, and few defined contribution participants do so. Future retirement security should no longer be a debate about defined benefit or defined contribution, as that is no longer the central issue in an age when both plan types paying lump-sum distributions at job change and retirement. The future debate must be about worker education on savings, investing, longevity, retiree health, long-term care, and what choices individuals can make to avoid running out of money before they die.

Chairman HOUGHTON. Okay. Please proceed.

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

Mr. GEBHARDTSBAUER. Chairman Houghton, Ranking Member Coyne, and distinguished Members of the Committee, thank you for inviting me here today to speak on this very important topic of defined benefit pension plans and retirement security.

As Chairman Houghton said, my name is Ron Gebhardtsbauer, and I am with the American Academy of Actuaries. We are the nonpartisan professional organization for actuaries of all practices in the United States.

Defined benefit plans are an essential component of retirement security in the United States along with defined contribution plans. While younger employees understand and value and appreciate the cash nature of a defined contribution plans, older employees and retirees will tell you that cash does not equal retirement security. A stable income for life does.

Thus, there are many advantages to having both types of plans and many large employers do just that. They will have a defined benefit plan and a 401(k).

In my written testimony I list many advantages that defined benefit plans over 401(k)s so I will just give a few here. For employees, defined benefit plans are more likely to provide a secure stable income for life. Employees won't have to worry about a bear market happening when they want to retire or after they retire.

For employers, defined benefit plans provide contribution flexibility. They can contribute more in good years and less in difficult years. For the Nation, defined benefit plans help reduce poverty better at older ages.

Unfortunately, the legal playing field is not level and as a consequence you will see from the chart that was just put up, that as Jack just mentioned, there has been a dramatic trend away from defined benefit plans toward 401(k)s.

You can think of the retirement system as a three-legged stool where one is Social Security, another is personal savings and another is employer pensions.

In the mid-1970s when ERISA was enacted, the employer leg was predominately defined benefit plans. Forty percent of the workforce was covered by defined benefit plans, the blue line. Now it is only half that and 401(k)s predominate, the green line.

Other defined contribution plans besides the 401(k)s are far below at only 12 percent. So, it is really not defined contributions that people like, it is 401(k)s. We knew that. The battle really was never between defined benefit and defined contribution. The battle was between defined benefit and 401(k)s and 401(k)s are winning for sure. For example, two-thirds of the money now going into retirement plans is going into 401(k)s.

That means that this three-legged stool is starting to look like just a two-legged stool because the employer leg and the personal savings leg are becoming very similar.

Having both defined benefit and defined contribution elements is good. Having only one is not good. It doesn't have to be this way. As I said, both defined benefit and defined contribution plans are essential to retirement security and both have their advantages, so it is important that the laws are structured so that defined benefit plans also have equal standing with 401(k)s so that employers and employees can have the best of both worlds.

As I just mentioned, the playingfield is not level for private sector companies. However, in the government or church sectors where these rules are not there, the playingfield is more level and in fact, guess what, there are more defined benefit plans in the church and government sectors.

So, how can we level this playingfield? The answer is not to hurt 401(k)s but to build on their successes. Why are they successful? Well, 401(k)s can have pre-tax employee contributions. In fact, government defined benefit plans can also have pre-tax contributions. Private sector companies cannot have them. So, that is one idea. You could let private sector DB Plans have pre-tax employee contributions.

Another is 401(k) plans can have employer matching contributions. In fact, in the nonprofit world you can have defined benefit

plans with matches, but again, in the for-profit world you can't do it.

So, here are two ideas in the 401(k) area that would be great if we could give it to the defined benefit area and level the playingfield. Thus, the answer is obvious. Include 401(k)s in the defined benefit area. You could call it a defined benefit 401(k) plan.

In my written testimony I suggest applying other 401(k) rules to the defined benefit world, such as phased requirement. A 401(k) can have phased retirement at age 59 and a half, but a defined benefit plan cannot.

Some of these ideas will create a more level playingfield. It is important that we act soon, because the earliest baby boomers are now at retirement age. Let us create laws so that they can have a more secure retirement. Thank you for the opportunity to speak. I look forward to your questions.

[The prepared statement of Mr. Gebhardtsbauer follows:]

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

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

Chairman Houghton, Ranking Member Coyne, and distinguished committee members, thank you for inviting me to testify on retirement security and defined benefit pension plans. My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the public policy organization for actuaries of all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis.

My written statement will focus on the three important issues for this hearing, namely:

1. The advantages and disadvantages of defined benefit (DB) pension plans;
2. Reasons for the decline in DB plans and implications; and
3. Remedies that will strengthen the DB system and retirement security.

In particular, I suggest that since DB and DC plans are both valuable for retirement security, the law provide a level playing field for both of them, so that one is not advantaged over another, and so that employers can choose the one that is right for them and their employees.

Definitions

Defined benefit (DB) plans specify the *benefit* employees will receive whenever they retire from employment (or quit or die). Thus, DB benefits can be any amount, calculated according to a formula and defined in a legal document.[1] For example, a traditional DB formula might be 1% of average compensation for every year worked. Thus, someone who worked 30 years would get 30% of his average compensation when he or she retired (on top of Social Security). Because the benefit is defined, employees know what benefit to expect when they retire, thus enabling them to plan ahead for retirement.

DB plans can also require contributions from employees, but they would be after-tax and thus less attractive to employees. Very few DB plans have employee contributions now.

[1] Pension laws restrict some of this flexibility for taxable employers, but they are less strict for churches and government plans.

Defined contribution (DC) plans specify the *contribution* the employer pays into the plan each year for the employee. The amount that employees get at retirement depends on how well the assets are invested in the meantime.

In 1978, Congress enacted section 401(k) of the Internal Revenue Code (IRC) to allow employees to make pre-tax employee contributions to certain DC plans and allow employers to match them. In a typical private sector **401(k) arrangement**, an employee might contribute 6% of wages (pre-tax), and the employer might match it 50¢ on the dollar, for a total employer contribution of 3% of that employee's wages. Thus, private sector employees often contribute more than the employer.

The Federal Employees Retirement Savings program acts something like a 401(k). If employees contribute 5% of wages (pre-tax), the federal government will match the employee contribution with another 5% of wages into the account. Unlike most private-sector 401(k) arrangements, however, the federal government contributes 1% of an employee's wages into his or her account, even if the employee contributes nothing.

Hybrid DB Plans that look like DC plans. DB plans can, if desired, mimic the benefits of DC plans, while providing flexibility in how much is contributed each year and where the funds are actually invested. They also have much more flexibility in design and can improve benefits quickly when needed (but are still funded gradually or in advance). Examples of hybrids can be found in church-wide plans in the U.S., and the Social Security system of Sweden. The U.S. rules for private-sector plans are unclear and thus make it difficult for companies to sponsor these plans, but many of them do exist and they are sometimes called cash balance plans.

Coverage History

Just after ERISA was signed into law in 1975, 40% of the labor force participated in a DB plan, and 16% participated in a DC plan (see Chart I). Today, however, the reverse is true: only 21% participate in a DB plan, while 46% participate in a DC plan.[2] As Chart I shows, almost anyone who participates in a pension plan is in a DC plan, and sometimes it is in addition to a DB plan.

Analysts have attributed the movement from DB to DC plans to: (1) larger DC plan benefits for young, mobile employees; (2) Employers attracting young employees with larger DC benefits upfront; and (3) DB benefits being more difficult to understand than DC benefits.

But I do not think that they have pinpointed the reason correctly, because, as I mentioned above, DB plans can look exactly like a DC plan to the participants. If the employer and employees wanted a DC plan, with employees being able to allocate their funds, they could simply change the DB plan formula to match the DC plan they wanted. There are plans in the U.S. that already do this. This approach would be much easier than having to terminate the DB plan and start up a DC plan from scratch. In addition, with the DB plan, the employer would keep the investment and contribution flexibility. So, there must be another reason.

I suggest that the biggest reason is that the playing field is not level for DB plans in the private sector. DC plans can have certain provisions, like pre-tax employee contributions, that DB plans cannot have. As evidence, I note that Canadian employers and state and local governments in the U.S. have a much more level playing field for DB plans (for example, they have pre-tax contributions), and all three have a much higher percentage of DB plans than in the U.S. private sector.[3]

The other primary reason is that pension law for private sector employers in the U.S. is much more onerous for DB plans. In fact, some pension professionals consider the regulations draconian. A study by the American Academy of Actuaries in 1993[4] showed that increased government regulation was the major factor in 44% of DB plan terminations in the late 1980s. Another study by Edwin Hustead of the Hay Group[5] noted that the administrative costs of a 10,000 person DB plan were less than the costs of a similar-sized DC plan in 1980, but by 1996, the DB costs had grown dramatically to almost 50% more than the DC plan's administrative costs. The important point here is that employers would like the flexibility to pick

[2] The 2000 Form 5500 data is not available yet, because pension plans file about 9 months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

[3] See Professor Robert Brown's paper discussing why it did not happen in Canada in the July 2001 issue of the North American Actuarial Journal (NAAJ), and discussions in the April 2002 NAAJ.

[4] *The Impact of Government Regulation on Defined Benefit Pension Plan Terminations*, a Special Report by the American Academy of Actuaries (March 1993).

[5] *Retirement Income Plan Administrative Expenses 1981 through 1996*, presented by Edwin C. Hustead of the Hay Group to the Pension Research Council conference (May 1996).

the plan that is right for both them and their employees. Because current law makes it difficult and expensive to maintain a DB plan, it creates a bias towards 401(k) arrangements. The law should let employers and employees make the right choice for their particular situations, not steer them to a particular option.

As further evidence, I note that there has also been a very large decline in DC plans that do not have a 401(k) arrangement. Chart II shows that of the 46% of the labor force participating in DC plans, 3/4ths of that number are in 401(k) arrangements. When you subtract out the 401(k) arrangements, you find that the remaining DC plans trail behind even DB plans. In fact, due to EGTRRA,[6] this 12% participating in "other DC plans" may practically disappear.

In fact, the "battle" has never been between DB and DC plans. It has been between 401(k) arrangements and all other plans. And 401(k)s are winning.

The third chart shows that two-thirds of all retirement contributions go to 401(k) arrangements, only 16% to other DCs and 17% to DBs.[7] This is a dramatic change during the past two decades. The elimination of so many DB plans represents an alarming reduction in retirement security, especially when the leading edge of the baby boom has reached age 55, a typical age for early retirement. The retirement dates of workers are now subject to the ups and downs of the markets, how well their funds are invested, and how much employees have contributed. And it could dramatically increase our nation's government assistance payments in 20 years for retirees who spend down their savings too fast.

I will discuss these concerns next in the section on the advantages and disadvantages of DB plans over 401(k) arrangements.

Advantages of DB Plans Versus 401(k)s to Employees

1. **Retirement Security.** DB plans provide employees with predictable incomes for life, no matter how long they live. That can help employees improve their retirement planning, because they have a better idea of what their pension will be.
2. **Risks.** DB plans can more effectively reduce the risks for employees than DC plans. Those risks include:
   a. **Investment risk.** In a DB plan, the employer generally assumes the investment risk, so employees will not suffer if they retire in a "bear" market. In a 401(k), older employees experiencing a bear market might have to delay retirement. For example, Chart IV shows that in 1973–74, stocks fell about 40%, while inflation went up more than 20%. Under this scenario, retirement income from a 401(k) would have been cut in half. While today's economic circumstances may not be as severe as they were in 1973–74, the current bear market may make individuals reluctant to retire at this time.[8]

      On the other hand, DB pension plans invested in stocks can smooth investment risk because:

      (1) the large size and long-term nature of a pension fund; and
      (2) the rules for funding and expensing allow employers flexibility in making contributions to the pension fund over time (although these are not as flexible as they used to be).[9]

   b. **Longevity risk.** The DB plan assumes the employee's longevity risk by paying a pension for the life of the worker (and the spouse, unless waived), no matter how long they live. Employees in a 401(k) arrangement can do this by buying an annuity after they retire, but not many do. Chart V shows various ways of taking out one's retirement money. A lifetime annuity guarantees that your money will not run out, no matter how long you live. In fact, the data in Chart V show that the annuity can provide the retiree with a larger income than if they manage their investments themselves. Some investment advisors suggest waiting until one's late 70s before buying an annuity. However, Chart IV reminds us that one keeps the investment risk until one buys the annuity. On the

[6] EGTRRA, the Economic Growth, Tax Relief and Reconciliation Act of 2001.

[7] The DB percentage may increase over the next few years because of the recent poor investment returns.

[8] Current workers could mitigate the effects of a bear market if they invest in GICs (Guaranteed Investment Contracts). But many people do not do so because GICs have lower average returns than stocks.

[9] The ability to smooth investment risk and manage contributions to the pension fund can increase the risk of insolvency, *i.e.*, the employer could go under when the plan is not fully funded. However, the Pension Benefit Guaranty Corporation (PBGC) would take over the plan in this case and make sure the benefits are paid.

other hand, a DB plan provides the same benefit no matter what the condition of the stock market when one retires. The DB pension is predictable, so the employee does not need to worry about investment or longevity risks.

c. **Inflation risk.** The employer generally assumes the inflation risk until the employee quits or retires. Some DB plans (such as Social Security) also take on the inflation risk after separation from employment by indexing benefits up to and after retirement. These plans are not common in the private sector, however, due to the volatile nature of inflation risk, and the complexities they bring to a pension plan. And since this benefits employees who no longer work for the employer, the employer has less incentive to assume this risk.

Many traditional DB plans provide "ad hoc" cost-of-living adjustment (COLAs) to retirees if inflation has been high, and assets have done well, but these are not a guarantee. Some analysts suggest that a 401(k) investing in stock can compensate for this risk, but as with variable annuities and stock indexes, stock returns do not correlate well with inflation over the short run. As mentioned before, in 1973 and 1974 stocks fell about 40%, while inflation went up more than 20% (see Chart IV). In difficult economic times, the best inflation hedge is staying in a DB plan or investing in inflation-indexed Treasury bonds, which a 401(k) or cash balance DB plan could do.

d. **Contribution risk.** DB plans generally cover almost all employees. However, in a 401(k) arrangement, even with tax advantages and employer matches, many workers will not or cannot contribute, and they will not have a benefit when they retire.

e. **Leakage risk.** This is a very important retirement security issue. Many DB plans still pay only annuities. However, in all 401(k) arrangements, employees can easily withdraw their money and spend it before retirement. Recent studies show that leakage occurs less often now for workers getting large lump sums, but it still happens often, especially with small lump sums. This means many employees will not have enough money to retire and may fall on government or family assistance in their old age. In addition, many employees will take their lump sum at retirement. They may think it is so large that they can retire early and/or spend some of it right away, assuming not all of it will be needed for retirement. Unfortunately, many people do not know how much money they will need to last the rest of their life, so they take too much out, too soon.

On the other hand, DB plans generally pay retirement benefits in the form of an annuity, not a lump sum. This is changing, but is still much less likely than in DC plans. In fact, some hybrid plans that look like DC plans are different in one respect—they do not pay lump sums. Employees may not appreciate this, but surveys of retirees suggest that they will appreciate it more after they retire. Cash is not the same thing as retirement security. For retirees, retirement security means a stable, lifetime income for life that is not affected by a bear market.

f. **Disability risk.** Many DB plans pay pensions upon disablement. DC plans are not as good at providing disability benefits as DB plans. For example, if disability occurs at a young age, a DC account will not be large enough to pay a disability pension. Thus, an employer that sponsors a DC plan often obtains disability coverage from an insurance company. However, that can be expensive or very difficult to find, especially for a small employer. With a DB plan, the employer self-insures this risk and does not have to pay for the insurer's loading charges and profits.

g. **Death risk.** DB pension plans pay pensions to spouses upon death of the employee, and the employer self-insures this risk. In a DC plan, the pension would be quite small for a young employee if it has to come from his or her account. Thus, many employers with only DC plans buy life insurance for the employees, for an extra charge.

h. **Early retirement risk.** In some DB plans, employees that are retired early can receive a subsidized early retirement benefit in order to manage the transition into retirement. In a 401(k), there will not be enough funds to provide a pension at an early age.

3. **Higher Returns.** DB plans have been more efficient at investing one large pot of funds, which means they can fund larger benefits with the same contribution, or the same benefit with a smaller contribution.

Recent figures from the DOL Abstract of Form 5500 data show that employees in 401(k) arrangements have been allocating just as much to stocks as the typical DB plan, so their average returns have been similar. However, much of this is due to their high concentration in employer stock. DOL data also show much higher levels of risk for employees in their 401(k) arrangements. The standard deviation of their returns is 2 to 3 times higher than in DB plans, per Table E24 of the DOL Abstract.

Advantages of DB Plans Versus 401(k)s to Employers

1. **Workforce Management.** DB plans help employers better manage their workforce. For example:
   - **a. Retirement windows.** Companies can use early retirement windows in DB plans to downsize in less painful ways than laying off employees, which can dispirit the workforce, the community, and customers. A 401(k) arrangement cannot provide early retirement windows.
   - **b. Retire older employees with dignity.** It is easier to retire older employees when one can give them a pension from a DB plan. If the employer had only a 401(k), the older employee may not have enough funds to retire due to a number of reasons: recent drops in the stock market, recent jumps in inflation, poor investing, low contribution levels, having borrowed against and spent his or her retirement funds. (This last situation can occur at employers with DB plans, but it is far less likely.)
   - **c. Create promotion potential for younger employees.** DB plans can help employers encourage workers to retire, allowing employers to promote and keep younger employees. As noted above, a 401(k) cannot be used this way.
   - **d. Retain employees.** DB plans can be somewhat "back-loaded" to provide incentives for employees to continue with the company. DC plans cannot be as back loaded as a final-pay DB plan.
   - **e. Recruit employees.** DB plans, like 401(k)s, can be more "front-loaded" if the employer wants to provide larger contributions upfront to attract employees.
   - **f. Satisfy union demands.** Unions are more likely to bargain for DB plans.
2. **Flexibility of DB plans.** As mentioned earlier, the DB plan is as flexible and creative as the ideas of its designer.
   - **a. Contribution flexibility.** Employers have some flexibility in the amount of contributions they make to DB plans each year. In good years, they can put in more, so that in tough years, they can afford to put in less. Employees do not need to worry about this because pension law has:
     - (1) minimum contribution requirements to keep DB plans well funded; and
     - (2) the PBGC protects employees in case the contribution requirements fail and lead to insolvency.

       A 401(k) does not have this flexibility. If an employer commits to a 50% match, the employer must pay it, no matter how much the employees contribute that year. The employer can reduce the contribution the next year.
   - **b. Investment flexibility.** Employers with DB plans can invest more in experimental assets classes, hard-to-value assets, and non-liquid assets. Since many other investors (including DC plans) will not or cannot do this, DB plans may earn a premium from these investments.
   - **c. Design flexibility.** DB benefit formulas can be amended easily. For example, an employer can:
     - (i) open a retirement window to encourage some quick retirements and pay for it gradually;
     - (ii) increase benefits to younger employees when the labor market is tight; and
     - (iii) provide an ad hoc COLA to retirees if inflation has been high and/or the pension plan's investments have done well.

       A 401(k) could not make these design changes.
3. **Tax Advantages.** All retirement plans get tax advantages, but DB plans can get larger ones, because employers can put more into a DB plan for older workers than into their 401(k). That result is possible because Congress at one time wanted to encourage DBs over 401(k)s, since DB plans were more likely to cover most employees than a 401(k). This particular DB advantage

has been greatly reduced in the recent past, as the maximum allowable contributions to 401(k)s have been increased.

4. **Increased Productivity.** Like 401(k)s and other DC plans, DB plans can improve employee morale and reduce employee fears about retirement, which can increase employee productivity. DB plans are more effective in reducing employee fear among older employees because DB pension benefits are more predictable.

Advantages of DB Plans Versus 401(k)s to the Nation

1. **DB pension plans are broader based.** Generally, a higher percentage of an employer's workforce is covered in a DB plan than in a 401(k), where the employee's contribution is voluntary. Thus, low-income workers are more likely to get a benefit from a DB plan and not depend on government assistance programs in retirement.
2. **DB surpluses helped the nation become competitive again.** In the 1980s and early 1990s, pension plan surpluses helped U.S. employers become competitive in world markets again. Early retirement windows helped companies become lean and pension funds made American markets among the most efficient in the world. 401(k)s cannot provide early retirement windows and may not be as good as DB plans at making our markets efficient.
3. **The trillions in DB assets promote national saving, investing, and certain markets that 401(k)s cannot, such as real estate.** DB plans provide huge sources of funds that reduce interest rates (and hence, borrowing costs) and provide start-up funds for IPOs, etc. In addition, DB plans can provide these funds to the real estate sector, and other less-liquid and hard-to-value assets. These sectors are already hurting due to the movement to 401(k)s and other DC plans that generally do not or cannot invest in these areas. In addition, the average amount of money per person is larger in DB plans than in DC plans.
4. **Reduces the nation's dependence on Social Security and government assistance programs.** Both DB and DC plans reduce the nation's dependence on government programs, but DB plans are better at it because DB participants are more likely to get a stable, predictable benefit for the rest of their lives.
5. **DB plans reduce poverty rates for the elderly.** Lifetime pension benefits from DB plans are more likely to help reduce poverty rates where they are the highest (very elderly single women), because they are level incomes payable for life.
6. **Defer tax revenues for a time when the country needs them.** The pension tax deferral moves tax revenues from the current year to a time when the country will most need them. In a decade or so, the nation will probably need more income taxes to pay for the bonds that Social Security will redeem to pay benefits. However, future income taxes may decrease as retirees pull money out of their Roth 401(k)s and IRAs free of taxation. Thus, the taxes on DB benefits will be needed more then than they are now.

   Furthermore, it should be noted that pensions should not be seen as a tax expenditure over the long run: they are tax-deferred, not tax-exempt. Over time, the tax revenues on pension income received in the future will likely exceed the tax revenues lost today (because pension plans earn higher returns than the additional borrowing required by the Treasury Department today when it gets less in taxes). A Cleveland Federal Reserve[10] report bolsters this point. It reported that tax rates in retirement are higher for many people because of the complex way in which Social Security is taxed above certain thresholds. Ultimately, the government may get more tax revenues from retirees than it lost by giving pension plans the benefit of tax deferral. (This quirk in Social Security taxation could be fixed by taxing it like pensions.)

Disadvantages and Challenges of DB Plans

The primary disadvantage of DB plans is that they do not provide much benefit to mobile employees. That may be true of traditional DB plans, but it does not have to be that way. DB plans can mimic DC plans. Front-loaded DB plans, for example, can pay just as much to mobile employees as DC plans.

[10] *Does Participating in a 401(k) Raise Your Lifetime Taxes?*, Working Paper 0108, by Jagadeesh Gokhale, Laurence J. Kotlikoff and Todd Neumann, Federal Reserve Bank of Cleveland (June 2001).

Some analysts also point out that DC plans are more popular because they are easier to understand. There are two responses to that:

1. cash may be more transparent to young employees, but when one is closer to retirement, a level pension is more transparent. Cash does not equal retirement security—a stable lifetime income does; and
2. young employees could convince the employer to sponsor a hybrid DB plan, which is just as transparent as a DC plan to younger employees. If given clear flexibility in pension law, private sector employers could make the monthly income from a hybrid plan more stable and transparent for older employees.

Since employees have the option of choosing their employer (and retirement benefits are part of that decision), federal policy has generally allowed employers flexibility to structure their compensation packages. Some employers and some employees will prefer more wages, some will prefer more benefits. The marketplace can sort out who works with whom.

Since DB plans can mimic DC plans, they have few disadvantages in comparison with DC plans, except that this flexibility itself can make DB plans more complex.

Finally and most importantly, the biggest disadvantage facing DB plans is that the law is more difficult on DB plans than DC plans. For example, DB plans cannot have pre-tax employee contributions and employer matches, and it is difficult to implement hybrid plans. More will be provided on this later.

Why the Move Away from DB Plans to 401(k)?

If DB plans have all these advantages and there are remedies for the disadvantages, why are so many employers moving to 401(k) arrangements (especially if a DB plan can mimic a DC plan)?

As suggested in the coverage section, the reason is that pension laws and regulations do not provide a level playing field for DB plans. Other DC plans (the ones without 401(k) features) are in decline too, so it is not the DC nature of the plan that is making employers switch. It is the advantages found in IRC Section 401(k). Thus, the first step might be to modify IRC Section 401(k) to include DB plans.

Furthermore, pension law is much more complex for a DB plan than for a DC plan. For example, we can create a DB plan to pay exactly the same benefits as a DC plan, but the law will not allow it. What is the policy reason for that? We need to level the playing field, so employers can choose the type of plan that works best for them and their employees.

Ways to Level the Playing Field

One quick way to level the playing field would be to include DB plans in IRC Section 401(k)[11]—in essence, creating a "DB 401(k)." It would be difficult to comply with all of the DB and 401(k) rules at the same time, some of which would contradict others. Thus, it will be preferable for the "DB 401(k)" plan generally to follow DB rules, with the following modifications:

1. **Allow voluntary pre-tax employee contributions in DB plans.**

   This is similar to what employers can do in 401(k)s now (and government employers can do in DB plans using the Section 414(h) pick-up rules). Employee deferrals could be tested using the 401(k) non-discrimination tests or the DB non-discrimination tests (but not both). These employee deferrals should be exempt from the 411(c)(2)(C) requirement to accumulate at 120% of the federal mid-term rate, as long as all participants can choose a market-related rate.

2. **Allow employer matches in DB plans.**

   Currently, many hospitals and other non-profits match employee 403(b) deferrals and put the match into the DB plan. However, for-profits cannot do that.

   Allowing the match in the DB plan under IRC § 401(k)(4)(A) could benefit employees by reducing investment and longevity risks on the match portion. Employers could benefit because they could pay for it out of surpluses in the DB plan. This would also raise revenue for the government.

[11] Congress could make a few changes to IRC 401(k) to allow 401(k) features in DB plans. For example, add the words "defined benefit plan" to the first sentences of IRC § 401(k)(1), § 401(k)(2), §§ 401(k)(2)(B)(i)(III) and (IV), and § 401(m)(1), and add a sentence to § 401(k) that Treasury will specify in regulations how the words "contributions" and "deferrals" can include pay credits to DB plans, as long as they have a market-related rate of return. Other sections of the law may need revisions, as well.

Note: Non-profits test these matches under the DB general test non-discrimination rules. Matches could be tested under either the 401(m) or the DB non-discrimination rules, but it does not make sense to force it to comply with both sets of non-discrimination rules.

3. Concerns on contingent accruals.

Some people may be concerned about allowing contingent accruals in DB plans. Non-profits, however, can already do it in DB plans, and for-profits can do it in profit-sharing plans. Banning the practice in DB plans simply encourages more profit-sharing and ESOP plans, where the risks for employees are higher.

Currently, DB plans generally provide benefits for most employees. Contingent accruals would mean that some employees (more likely lower-paid ones) might not make a contribution, and therefore would not get an accrual. Some possible remedies are:

a. Non-elective employer contributions. Some employers provide non-elective employer contributions to everyone in order to meet the 401(k)(3) nondiscrimination tests. Pay credits that already exist in a cash balance plan could also help satisfy these rules.

When the 401(k) merges into a cash balance plan, the 401(k) accruals could be on top of the non-elective cash balance accruals. (Employee advocates will be interested in surveys showing that pay credits in cash balance plans and other hybrid plans are less likely to be integrated than traditional DB plans.)

b. Safe harbor rules. IRC Section 401(k)(12)(C) allows employers to avoid the non-discrimination tests in their 401(k) if they promise a 100% match on the first 3% of pay, and a 50% match on the next 2% of pay. Allowing that on the DB side might raise concerns for employees.

Past remedies for this concern have been to require the employer to make the first contribution. For example, in the federal employee Thrift Savings Plan, the employer makes an automatic contribution equal to 1% of pay to everyone first, and then contributes the match on top.

Policymakers need to be careful about placing more requirements (like an automatic or minimum contribution) on the "DB 401(k)" than they have for the DC 401(k). If they do, the playing field will not be level, and the law will bias employers to 401(k)s, even if they and their employees would prefer a DB plan.

One remedy would be to also require the automatic contribution for the DC 401(k), but that would probably result in some employers dropping their DC 401(k). Another possible remedy would be to give the DB 401(k) an offsetting advantage over the DC 401(k), such as allowing employers to use the DB plan's surplus to pay for the match. This might be enough to motivate some employers (those with over-funded DB plans) to move their 401(k) to the DB side.

c. Allow the IRC Section 25B tax credit match in the DB 401(k). Low-income employees should be able to get the tax credit match in a DB plan, just as they can now have in a DC plan (due to EGTRRA[12]). This will help encourage more low-income employees to participate.

d. Better returns than Treasury rates: This is a very important change in the law. In order to encourage employees to make contributions, it will help greatly if the law made it easier for DB plans to provide higher rates of return on employee contributions (deferrals, matches, and non-elective contributions). Some people in the IRS use section 417(e) to make it difficult to provide a rate of return higher than the Treasury rate. Since employees can get a higher return in their DC 401(k), why would they voluntarily contribute into their DB 401(k) if the return were less?

Lawmakers could clarify that the IRC handles this well in section 411(a)(7)(A)(i) already. That would ensure that DB accounts could provide a market-related rate without causing myriad problems for the DB plan.[13] The 417(e) rule was created for traditional DB plans that prom-

[12] In EGTRRA, the current tax credit rule has cliffs. The tax credit match drops from 50% to 20% when adjusted gross income (AGI) goes over $15,000. Thus, someone earning one more dollar means they could lose 30% of $2,000 or $600 in taxes. This could be fixed by making the tax credit match equal to 50% of the contribution minus, for example, 3% of their AGI.

[13] Alternatively, the accrued benefit could be defined to be the account balance in hybrid plans.

ise a pension at retirement. It was enacted in the early 1980s when discount rates were very high and lump sums were very small. Employees then sued for larger lump sums.

This is not a problem for account balances. For example, one would never have thought to apply this rule to a 401(k), and similarly, it does not make sense to apply it to this DB 401(k). Doing so would not level the playing field.

It would make more sense for the law to have a minimum rate of return based on market rates (not a maximum rate). That would especially help older employees who are more likely to have large accounts due to their longer periods of service.

Other ideas are suggested by Pension Equity Plans (PEPs), which are similar to cash balance plans except that they effectively increase the account by the increase in the employee's wages. Other plans might want to increase accounts by a productivity index or the GDP (like Sweden).

If IRC Section 417(e) is fixed for account-based plans, it should include these possibilities too. For example, it could allow interest credits equal to any market-related return or any wage index.

e. Allow the special rule 401(k)s have for early participation. Policymakers could encourage employers to provide DB plans with automatic deferral elections at hire. This can be done by opening up IRC Section 401(k)(3)(F) to deferrals in DB plans, and as in 401(k), exempting people who have not met the age and service rules in ERISA from the non-discrimination tests.

f. Encourage default automatic elections. Pension law could encourage employers to have automatic deferral elections at hire and at each pay anniversary. The law could give specific approval to have a default amount placed in a default fund. (It could increase an employee's deferrals by 1% or 2% of pay, up to a total of 6% of pay unless the employee affirmatively requests otherwise.) A DB fund with a default return equal to a long-term Treasury rate, plus 1% or 2%, or a corporate bond rate, could make this default more appealing.

g. Phased retirement. Employees over age 59‡ who are phasing into retirement and taking distributions from their 401(k) will not want to lose this ability if it is merged into their DB plan. Employees in DB plans should be able to get distributions at age 59‡ just as in their DC 401(k) plan, as permitted under IRC § 401(k)(2)(B). Otherwise, employees might contribute less to the DB 401(k).

The law might also allow phased retirement after 30 years of service, if the employee is at least age 55. This would help employees who want to go part-time to get some of the early retirement subsidy in the plan, if applicable.

h. Maximums applied separately: The maximum benefit, contribution, and deferral rules should be applied separately to the DB and 401(k) parts. Otherwise, if an employer folds its 401(k) into a generous DB plan, some contributions/deferrals might have to be reduced.

4. Allow employers to change asset choices.

Employers should still be able to change asset options, just as in a 401(k), without worrying about any requirements in Section 411(d)(6). The plan could be required to continue having at least a couple market-related returns, a bond rate, and a money market rate available.

For example, if an index or mutual fund disappeared, the plan would need to change it to some other market-related return.

5. Accrual rules.

It might be preferable to have the DB 401(k) accounts follow the DC accrual rules, not the DB accrual rules (or at the very least, allow the plan to have "greater of" formulas and allow them to test using the DB accrual rules on each formula separately). This would also ensure that increases (and decreases) in an employee's contribution (and therefore their match in the DB plan) would not cause any violation of the accrual rules.

This might also give policymakers a chance to clarify and simplify accrual rules for hybrid plans. It would make sense to test pay credits by using an age-weighted formula with a maximum discount rate of 8%, for example. It would still produce accruals that were much less age-weighted than a traditional DB plan because DB plans are also age-weighted through the increase in the final pay average. If less age weighting is desired, the rule could limit the discount rate to, for example, 6% or 5%.

6. Switching between DB and account.

As long as the account earns a market rate, employees could be allowed to switch the lump sum value of their DB benefit to the account side when they leave the employer—instead of taking the lump sum—and move it back at old age in order to convert to an annuity, perhaps at the date minimum distributions are required. Some pension plans do this already, but one has to move between plans in order to do it.

7. New funding rule for "DB 401(k)s."

In addition, the minimum funding rules will need to be modified to accommodate the "DB 401(k)." A simplified funding rule might work, such as 90% of the current pay credits to the account or, if greater, 20% of the amount by which the account balances (with minimum) exceed the plan assets.

8. Other uses of 410(k) funds in DBs.

In addition, this new feature could be added to an already existing DB plan. It would create a plan that has significant accounts for young employees and old-style annuity guarantees for older employees. Other uses for this idea would be as follows:

a. The extra assets in the accounts could be used to provide COLAs to traditional DB pensions or past service credits for prior service or prior jobs (which would help make DB plans more portable).

b. The "DB 401(k)" idea could allow floor-offset plans to be aggregated into one DB plan, so the employee would get the greater of an account and a traditional DB benefit. It would make more sense to the employee (since it will get rid of the offset) and entail less risk to the employer, since the assets would all be in one plan. Currently, the assets needed in the DB component of a floor-offset arrangement can be very unpredictable. It could be large, if the DC plan has poor investment returns, or it could be zero, if the DC plan has great investment returns (in which case, the employer will have a difficult time trying to get the assets back).

9. Conversions from 401(k) to "DB 401(k)."

This idea should not be limited only to new plans. Allowing conversions would mean the 401(k) would not have to be terminated in order to convert it. To encourage employers to convert their current 401(k)s to this plan, it will be important to enact the suggestions in the above section. Whenever a new advantage is provided to the current DC 401(k)s rules, it would need to be provided on the DB side too,[14] or employers might convert back to the original 401(k).

10. Other ideas for leveling the playing field that do not involve § 401(k) include:

a. Simplify minimum funding rules for DB plans. The current rules are incredibly complex and the Academy has assigned a task force to make suggestions in this area.

b. Fix the discount rate for funding liabilities. Due to the current abnormally low Treasury rates, the IRC was going to force employers to contribute too much to their pension plans. Congress resolved this concern by passing a temporary rule that allows employers to use a higher discount rate, but it is in effect only through 2003. A permanent fix is needed, and policymakers should consider using annuity prices or corporate bond rates (which is what annuity pricing is based on) for setting the discount rates. Some have suggested using government rates, but they are not capable of estimating annuity prices and can create problems. If Treasury rates went back to having the same margins with corporate bond rates, a fix based on a government rate would not encourage adequate funding which would cause problems for the PBGC.

c. Clarify the laws for hybrid plans. Hybrid, cash balance, and pension equity plans have been around for about two decades, but the laws have not been modified to handle these new kinds of retirement plans. Consequently, new rules are being created through court decisions, which try to adapt the old rules to the new plans. Since there has been no clear guidance from Congress to the courts, some employers are falling into traps that they did not know existed.

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[14] And similarly, if the "DB 401(k)" has a restriction placed on it, it should also be placed on the 401(k), too. That is why it makes sense to have the rules in the same place in IRC § 401(k) for both DB and DC plans.

d. **Allow employers to raise the pension plan's normal retirement age.** Currently a pension plan cannot raise its normal retirement age above 65. Congress has already raised the retirement age for Social Security. It is inconsistent with Congress' pro-work policy for older Americans for the retirement age for pension plans to be kept at age 65. Allowing pension plans to use the same normal retirement age as Social Security would make sense.

e. **Revise Congressional budget rules to reflect future tax revenue received on pensions.** Whenever Congress tries to improve retirement security by increasing pension coverage to the part of the working force without pensions, current budget rules show the loss in revenue today. But this misses the fact that tax revenue in the out years will increase and pay back the loss in revenue today (as discussed on page 9).

If the budget rules could reflect these pension tax deferrals as budget neutral, it would be easier to pass solutions to the pension coverage problem.

The budget rules already allow this under the Credit Reform Act of 1990 for government loans by offsetting the payments received in the out years for housing loans, school loans, rural electrification loans, the Disaster Loan fund, loans for rural development, the Business Loan Investment Fund, mortgage guarantees, international aid, the Export-Import Bank, foreign military sales, and the Overseas Private Investment Corporation. The reason behind passing the Credit Reform Act was similar: it helped Congress make the best financial decision when deciding whether to provide loans or loan guarantees. This law could also be used to handle the pension tax deferral, showing that it is clearly a tax deferral, not a tax exemption.

Conclusion

DB plans were once the most common way of providing retirement security to America's workers. However, due to the non-level playing field created by pension laws, many employers have switched to 401(k) plans, which do not provide the same level of retirement security as traditional DB plans. One way to level the playing field is to allow DB plans the same flexibility as 401(k)s. Other ideas (such as fixing the discount rates and simplifying the minimum funding rules[15]) are discussed in my testimony, and I would be glad to analyze the effects of any proposals you wish to consider. Thank you for the opportunity to share my views today.

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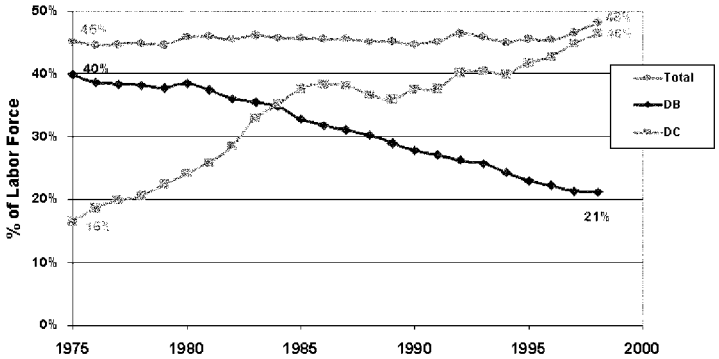
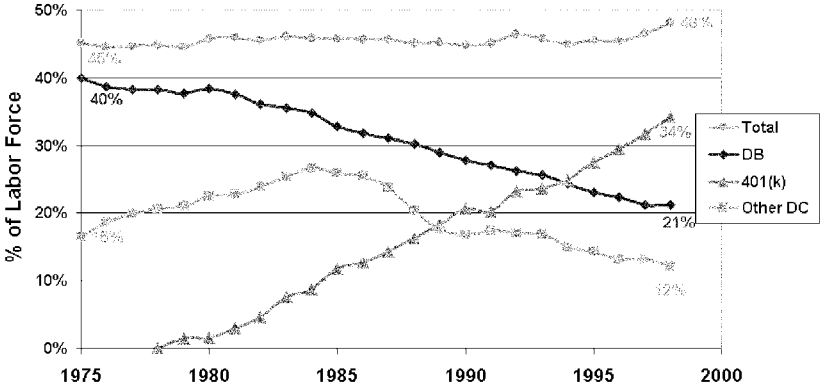
[15] Also, see the suggestions in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's web site at http://www.actuary.org/pdf/pension/ERISA—071701.pdf).

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

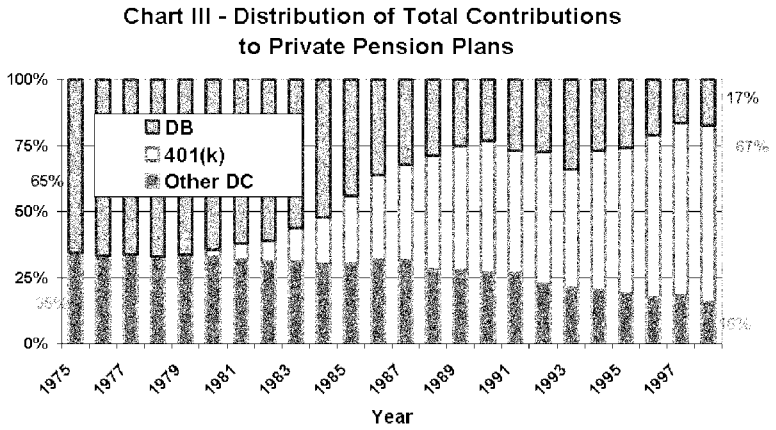


About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

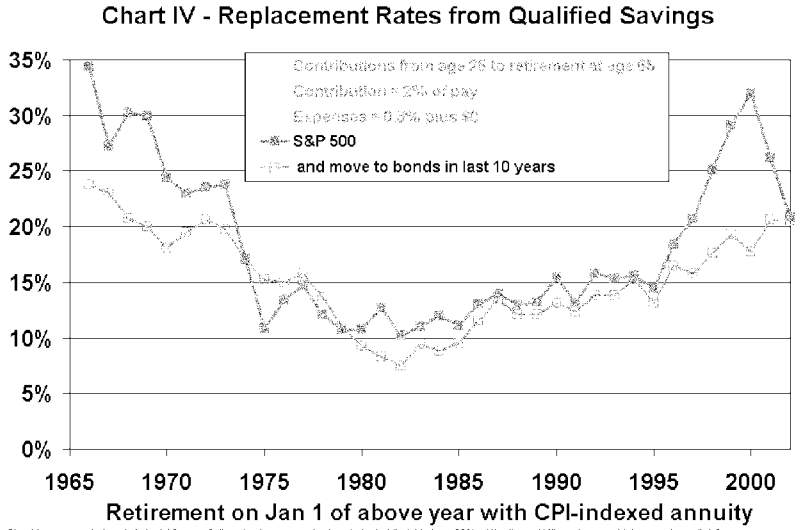
Chart II - Participation Rates in Pension Plans (by type)



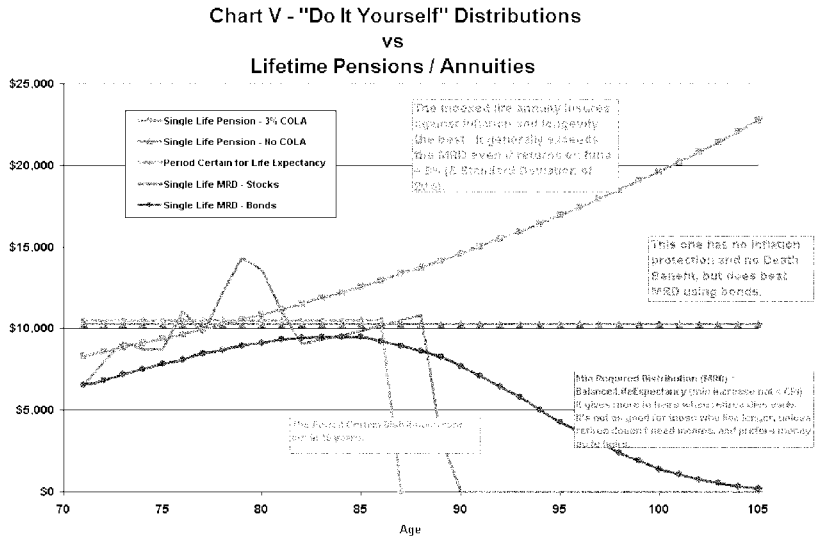
It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA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



It's not a battle between DB and DC. It's a battle between DB/DC and 401(k), and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Source: Tables E14 and E23 of DOL/PWBA's Abstract of 1998 Form 5500 data. The 401(k) amounts are estimated in years 1978 to 1983



Should you move to bonds in last 10 years? It varies less over short periods, but it yields less 86% of the time. Will you know which years to switch?



Chairman HOUGHTON. Thank you very much, Mr. Gebhardtsbauer. Now, Ms. Friedman.

STATEMENT OF KAREN D. FRIEDMAN, DIRECTOR, POLICY STRATEGIES, AND COORDINATOR, CONVERSATION ON COVERAGE, PENSION RIGHTS CENTER

Ms. FRIEDMAN. Mr. Chairman, with your permission I would like to summarize our prepared statement and submit the longer statement into the record.

Chairman HOUGHTON. Without objection.

Ms. FRIEDMAN. Mr. Chairman, Mr. Coyne, Members of the Subcommittee, I am Karen Friedman. I am the Director of the Pension Rights Center's Conversation on Coverage, a new project funded by the Ford Foundation to launch a national dialog on ways of increasing pensions and savings for America workers. Thank you so much for inviting us today to talk about the critical role that defined benefit plans play in retirement security in this country.

If there is a silver lining in the Enron crisis, it is the recognition of the importance of pensions. Up until recently, most experts contended that traditional employer-paid pensions had lost their luster, overshadowed by popular 401(k) plans. In the wake of Enron, there has been a resurgence of interest among experts on all sides of the issue in finding new ways of encouraging defined benefit plans.

Two decades ago, most large companies routinely offered traditional pensions to their workers, recognizing that these retirement benefits were a critical component of a larger compensation package. The deal was that if employees remain loyal to companies, worked hard and met certain requirements, they would be rewarded with a monthly benefit for life backed by a Federal guarantee. In recent years that trend has been reversed.

The Center has long been troubled that companies have been dropping good, solid employer-paid pension plans and replacing them with do-it-yourself savings plans that put the risk and responsibility of investing on the shoulders of individuals. A recent study by NYU economist, Edward Wolfe shows that despite stock market gains and the rapid growth of 401(k) plans, the typical American facing retirement today has had a decline in retirement wealth relative to other generations of near retirees.

The reasons for this decline are not hard to find. Unlike defined benefit plans where employers put money in for employees at all income levels, 401(k)s only benefit those employees who can afford to put money into the plans, keep it in the plans until retirement age, and who have the luck to get good investment returns.

Employers point to over regulation as the cause for the decline of DB plans. We think that reduced regulation may have a role to play. Relaxation of rules by administrative agencies not only invited the growth of 401(k) plans, but also permitted the expansion of top hat plans which allowed all executives to provide extremely generous retirement packages for themselves outside of the defined benefit plans that are covering their employees.

Whatever the reason for the decline in traditional plans, there is a growing consensus that something has to be done to try to encourage these plans. What incentives are there to provide defined benefit plans? The principal incentive has generally been considered to be the tax breaks offered to employers to set up and contribute to plans. For smaller businesses, the carrot has often been the ability to provide large retirement benefits for the company owners.

There is no question, retirement income must be enhanced for working Americans. Half of all private sector workers have no retirement plan other than Social Security and there is no question that people need both pensions and Social Security to make ends meet.

Last July, the Pension Rights Center convened the Conversation on Coverage to bring together experts from a wide variety of perspectives to examine new ways of expanding retirement income for working Americans.

We thought we would share with you today a few of the proposals that address either the expansion of defined benefit coverage or proposals that included key elements of defined benefit plans, sort of what Ron has been talking about.

As an incentive for small companies to adopt defined benefit plans, one proposal increases the amount small business owners could set aside for their own retirement on a tax-favored basis. In exchange for this carrot, the company would have to cover all workers and provide fair benefits across the board.

A variation of this proposal was introduced by Congressman Coyne in a Smart Plan as part of his larger bill which we strongly support, and in 1997 by Congressman Pomeroy, and also Nancy Johnson.

One proposal created the benefit concepts with newer cash balance ideas. Another proposal created the concept for a hybrid plan in which older employees would receive lifetime pensions based on their final pay while younger employees would receive portable

benefits based on contributions made for them. There were other proposals that would take key elements of defined benefit plans and export them into defined contribution structures.

For instance, one proposal called for the creation of financial institutions similar to TI and Cref to relieve small employers of administrative burdens and fiduciary responsibilities while offering employees pooled professional investment management and insured lifetime annuities. There was a variety of other creative proposals presented in the Conversation, including the development of new kinds of multi-employer plans for unrelated employers, as well as a number of proposals that built on the low income tax credit included in last year's tax bill.

Some Conversation participants also suggested the need for developing insurance for 401(k) plans. There are no easy solutions when it comes to retirement security. It will take all of us working together to find approaches that will do the job effectively by striking a balance between burdens and costs to employers and fairness and adequacy for employees.

The Pension Rights Center looks forward to working with the Members of this Subcommittee as we move into the second stage of the Conversation on Coverage. Thank you for inviting me to appear today. I would be happy to answer your questions.

[The prepared statement of Ms. Friedman follows:]

Statement of Karen D. Friedman, Director, Policy Strategies, and Coordinator, Conversation on Coverage, Pension Rights Center

Mr. Chairman, Members of the Subcommittee, I am Karen Friedman, Director of Policy Strategies for the Pension Rights Center, a 26-year-old consumer rights organization dedicated to promoting the retirement security of workers, retirees and their families. I am also coordinator of the Center's Conversation on Coverage, a new initiative funded by the Ford Foundation to launch a national dialogue on ways of increasing pensions and savings for American workers.

The Pension Rights Center welcomes the opportunity to testify today about defined benefit plans and their important role in providing adequate, guaranteed retirement income to millions of Americans. If there is a silver lining in the Enron crisis, it is the recognition of the importance of pensions. Retirement income issues have surfaced as a critical concern in the public consciousness, and are rising to a priority issue on the national political agenda.

Up until recently, most experts in the field contended that traditional employer-paid defined benefit plans had lost their luster, overshadowed by popular 401(k) plans. No wonder. Throughout the past decade financial columnists and CEOs alike had preached that everyone could become millionaires through their 401(k) plans. Traditional defined benefit plans seemed to be going the way of the dinosaur—heading for extinction.

But seemingly overnight attitudes have changed. In the wake of the collapse of 401(k) plans at Enron and Global Crossing, and losses at Lucent, Kmart and Polaroid, there has been a resurgence of interest on the part of experts on all sides of the issue in finding new ways of encouraging defined benefit plans. Although there may not be a unanimous vision of how to go about doing this, representatives of both business and labor appear to be genuinely committed to finding ways of maintaining and expanding these plans.

Two decades ago, most large companies routinely offered traditional employer-paid defined benefit pensions to their workers, recognizing that these retirement benefits were a critical component of a larger compensation package. The deal was that if employees remained loyal to companies, worked hard and met certain requirements, they would be rewarded with a specific monthly amount for life that was backed by a federal private pension insurance program. Employees and employers both understood the nature of the bargain: employees would get a lower salary in exchange for getting the good pension they needed to supplement their Social Security payments.

But in recent years that trend that has been reversed. While the percentage of the private sector workforce participating in employer-sponsored retirement plans has remained fairly constant,[1] the percentage of the workforce in old-style pension and profit sharing plans is shrinking rapidly as more and more companies are replacing them with savings plans. Looking just at defined benefit plans, the percentage of the private workforce covered has declined by 40 percent.[2] The switch to savings plans is most noticeable in small businesses, which have dropped their plans entirely. But there has also been a disturbing shift in large companies, which have effectively frozen their traditional plans and told their employees to save for themselves through their 401(k)s. Only among union members in these companies are defined benefit plans still strong.[3]

In fact, this type of cutback is exactly what happened at Enron. As described in the *Wall Street Journal*, Enron, like so many other companies, had taken advantage of the leeway provided by accounting practices and lax federal regulation to cut back on the employees' underlying pension plan. In 1987, Enron froze its traditional plan that offered lifetime insured benefits and used the plan's "surplus" assets to create a "floor offset" plan that primarily relied on company stock to provide benefits. Nine years later, that plan, in turn, was replaced by a barebones new type of pension plan (that significantly reduced the expected benefits of older employees), supplemented by the 401(k). All of these changes were highly technical moves that effectively allowed the company to cut future benefits, increase the pension "surplus" and, by dint of an accounting maneuver, use pension earnings to artificially inflate corporate earnings on the company's balance sheet. Of course, when the company's paper profits went up, so did the compensation packages of corporate officials like CEO Kenneth Lay.[4]

Long before Enron collapsed, the Center issued strong warnings about the trend away from traditional pensions to less secure 401(k) plans.[5] We have been troubled that companies have been dropping good, solid, employer-paid pension plans and replacing them with do-it-yourself savings plans that put the risk and responsibility of investing on the shoulders of individuals. Employees have not complained about these "pension paycuts" because they have not understood what was happening, and have been led to believe that they could become millionaires in the stock market through their 401(k) investments. But now we see that for most employees the promises of 401(k) riches were largely an illusion. The sad truth is that even before Enron and the recent stock market downturn, half of all employees contributing to 401(k) plans had less than $12,000 in their accounts.[6]

Rather than increasing the retirement wealth of rank and file workers, the advent of 401(k)s appears to have actually reduced it. A recent study by New York University economist Edward N. Wolff, published by the Economic Policy Institute, shows that despite stock market gains and the rapid proliferation of 401(k) plans, the typical American facing retirement has had a decline in retirement wealth relative to other generations of near-retirees.[7] According to Professor Wolff, every group of near-retirees except those at the very top lost ground compared to their counterparts in 1983. He cites the contraction of defined benefit plans as a core reason for

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[1] Alicia H. Munnell and Annika Sundén, "Private Pensions: Coverage and Benefit Trends," Center for Retirement Research, 2001, p. 6.

[2] U.S. Department of Labor Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports*, Number 11, Winter 2001–2002, p. 68, Table E4b.

[3] 70 percent of union workers have defined benefit retirement coverage, compared with 16 percent of nonunion workers. "The Retirement Double Standard," from the AFL–CIO web site, www.AFLCIO.org

[4] Ellen E. Schultz and Theo Francis, "Enron Pensions Had More Room at the Top," *Wall Street Journal*, January 23, 2002. Ken Lay will receive a lifetime pension of $475,042 a year, plus a company-paid $12 million insurance policy. In contrast, long-service Enron employees have been left with almost nothing. One 25-year employee told *USA Today* that he would receive a $221 per month benefit from the original defined benefit pension plan, nothing from the "floor offset plan," and a total of $15,000 from the new cash balance pension plan. Christine Dugas, "Enron's Dive Destroys Workers' Pensions", *USA Today*, February 6, 2002.

[5] Karen W. Ferguson, "How 401(k)s Hurt Lower-Paid Workers, *The New York Times*, April 17, 1986, p.F2

[6] Patrick J. Purcell, *Retirement Savings and Household Wealth in 1998: Analysis of Census Bureau Data,* Congressional Research Service, 2002, p. 13.

[7] For the typical (median) household headed by a person age 47–64 retirement wealth declined by 11 percent between 1983 and 1998. Edward N. Wolff, *Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire*, Economic Policy Institute, 2002, p.25, pp. 22–23, Table 8.

this decline in household wealth particularly among low-and moderate-income households.

The reasons for this decline are not hard to find. Unlike defined benefit plans, where employers put money in for employees at all income levels, 401(k)s only benefit those employees who can afford to put money into the plans, keep it in the plans until retirement age, and take the risks needed to get good investment returns. As Enron has shown, in many cases, these plans also offer employees an often-irresistible opportunity to gamble on a "sure thing"—their companies' stock.

Employer organizations contend that their members have dropped or cut back on defined benefit plans because increases in government regulation over the years have made the plans too costly to maintain. But it is equally plausible that these plans have declined because of *reductions* in government regulation. Relaxation of rules by administrative agencies not only invited the adoption of 401(k) plans, which gave company officials an easy way to divert attention from cost-saving cutbacks in their defined benefit plans, but also permitted the expansion of "top hat" plans, which allowed these executives to provide extremely generous retirement packages for themselves outside of the defined benefit plans covering their employees.

Whatever the reasons for the decline in traditional pensions, there is a growing consensus that something should be done to try to encourage the defined benefit plans, or at least plans that incorporate certain key elements of defined benefit plans.

From an employees' perspective, the most important features of defined benefit plans are that these plans are insured, professionally managed, employer-paid, and that they provide lifetime benefits to workers at all income levels—not just those who can afford to save for themselves.

At the same time, there are shortcomings in the defined benefit system that also need to be acknowledged and addressed. For instance, traditional plans often use complicated formulas that disproportionately favor certain groups of employees over others—most commonly, higher-paid and older employees—and for that reason can be perceived as unduly complex and unfair. Also, unlike 401(k)s their benefits are not portable. If employees leave defined benefit plans early in their work lives, they usually have to wait until retirement age to collect their benefits—when the value of the benefits will have been eroded by inflation. *And* retirees' fixed benefits are rarely adjusted for increases in the cost of living. Although these issues can be addressed within the current defined benefit structure, this would add costs which, up until now, employers have been unwilling to assume.

What incentives are there for employers to provide defined benefit plans when they can simply offer cheaper 401(k) plans? Why should they assume the risk and responsibility—not to mention the cost—of providing these plans, when it is much easier and cheaper simply to tell employees to save for themselves, and provide for their own retirement through "nonqualified plans"?

The principal incentive has generally been considered to be the tax breaks offered to employers to set up and contribute to plans—which, when federal, military and state government plans are added, constitute the largest of all of the nation's federal tax subsidies.[8] For smaller businesses, the "carrot" has often been the ability to provide large retirement benefits for themselves. To a lesser extent now than in the past, another inducement to set up defined benefit plans has been that they can reward loyal, longer-service employees, and help "manage" the workforce (for example, by encouraging older employees to leave the workforce at early retirement age). Where employees are represented by a union, collective bargaining can also provide an effective incentive for setting up a plan.

The question is whether these incentives are sufficient to encourage employers to set up (and continue) plans that will provide meaningful benefits for American workers. Last year's tax law, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was premised on the notion that increased tax incentives would encourage the formation of private retirement plans. The problem is that tax relief was provided not just to employers to encourage them to maintain defined benefit plans, but also to employees and employers to increase contributions to 401(k)s. Once the law is phased in, older higher-income employees will be able to reduce their taxable income by $20,000 a year (and their employers will be able to

[8] The Joint Committee on Taxation estimates the revenue loss for employer contributions to retirement plans to be $84 billion this year, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2001–2002, p.22*, Table 1.

contribute an additional $20,000 as a match to the employees' contributions).[9] The danger is that EGTRRA may have made 401(k)s so attractive to better-off employees that it will be even easier for employers to reduce costs by cutting back on defined benefit plans in favor of do-it-yourself arrangements.

The events of the last eight months and public focus on this issue have given us a unique opportunity to reexamine the nation's private retirement income policies. What can be done to enhance retirement income for working Americans? There is an urgent need to answer this question. Half of all private sector workers have no retirement plan other than Social Security, and of the 51 million workers with plans, 19 million, or roughly 37 percent, have 401(k)s as their only plan.[10] The typical American retiree without an adequate private retirement plan, will have little more than Social Security, which will provide only half of what he or she will need to maintain his or her standard of living in retirement—less than the minimum wage!

To begin the process of addressing this critical issue, last July the Pension Rights Center convened the Conversation on Coverage. With primary funding from the Ford Foundation and the W.K. Kellogg Foundation, we brought together 75 experts from business, labor, academia, financial, consumer and retiree organizations to look at new ways to deliver benefits to working Americans. The focus of the Conversation was on developing new ways of delivering benefits to employees who have no plans at all, particularly low- and moderate-income wage earners. Our goal was to spark a national dialogue by inviting representatives of all points of view to develop workable solutions in a consensus setting.

The Conversation participants reviewed an array of proposals that sought to expand coverage either through the existing employer-based system or by creating new institutions and structures. In coming months, we will be releasing a white paper, to be published by the Century Foundation, which will expand on these ideas and start the next stage of the Conversation. We thought it might be helpful to share with you a few of the proposals that were presented at the Conversation that addressed the expansion of defined benefit coverage or that included key elements of defined benefits plans. These are just a few of the many creative suggestions offered at the Conversation on Coverage.

One proposal was aimed at increasing incentives for small business owners to set up defined benefit plans by increasing the amounts they could set aside for their own retirement on a tax favored basis. This proposal provides an explicit trade off: In exchange for the "carrot" for business owners, the plan would be barred from taking advantage of current rules that allow employers to exclude workers from their plans, and pay proportionately larger benefits to higher-paid employees than rank and file workers. Also, benefits would be portable and, in one version of this proposal, insured by the Pension Benefit Guaranty Corporation. Two variations of this proposal have already been introduced into Congress. Most recently, Congressman William Coyne included the "SMART" plan (Secure Money Annuity or Retirement Trusts) as Section 402 of his Retirement Opportunities Expansion Act of 2001 (H.R. 3488). Previously, in 1997, Congresswoman Nancy Johnson and Congressman Early Pomeroy had introduced "SAFE", The Secure Assets for Employees Plan Act (H.R. 1656).

A proposal designed to appeal to larger employers was presented by Jim Davis, Principal and Consulting Actuary for Milliman USA. The "Individual Advantage Plan" would merge traditional defined benefit concepts with newer "cash balance" ideas. Older employees would receive the insured lifetime pensions based on their final pay that they had counted on receiving, while younger employees would receive portable benefits based on contributions that would accumulate as if they had been put into individual accounts. Since neither group would get as much as under a traditional defined benefit plan or a cash balance plan, the overall cost to the employer (and the revenue loss to the Treasury) would be the same. The incentive for the employer would be that dollars would be allocated in ways that would help companies attract younger workers, and retain older employees.

A very different proposal, that would take key elements of defined benefit plans and place them into a defined contribution structure, was presented by Professor Norman Stein of the University of Alabama School of Law. His approach, which had been developed by a nonpartisan group of twenty pension experts, was designed to

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[9] The President's Budget for fiscal year 2003 estimates that the revenue loss from 401(k)s will be $60 billion next year. "Analytical Perspective Fiscal Year 2003", *U.S. Budget for Fiscal Year 2003*, Vol. 4, p. 107, Table 6–3.

[10] *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports*, U.S. Department of Labor Pension and Welfare Benefits Administration, Number 11, Winter 2001–2002, p. 68, Table E4b.

encourage smaller employers to contribute to plans by relieving them of administrative burdens and fiduciary responsibilities, and giving them the flexibility of deciding each year whether to contribute. Like defined benefit plans, this approach, called the "Pensions 2000" proposal, would offer pooled, professional investment management, and lifetime annuities, that would be insured when employees retired. Also, like defined benefit plans, the money would be locked in until retirement age.

Unlike defined benefit plans, and unlike the SAFE/SMART and Individual Advantage Plan approaches, the Pension 2000 design envisions that employees, as well as employers, would be able to make tax deferred contributions to the plans, which would be administered by financial institutions. These contributions would be structured as a "reverse 401(k)": The employees' contributions would "match" the employer contributions. Those employees who could afford to put money in the plan would be able contribute up to $2 for each $1 contributed by their employer. The others, who could not afford to contribute, would at least be assured of getting the employers' contributions.

There were a variety of other proposals presented at the Conversation, including the development of new kinds of multiemployer plans for unrelated employers as well a number of proposals that built on the low-income tax credit included in last year's tax bill. A one-page summary of each of these proposals can be found on the Conversation's website www.pensioncoverage.net. In addition, participants at the Conversation suggested the need to develop new concepts, such as insurance for 401(k) plans—an idea that has generated particular interest since Enron's collapse.

To say the obvious, there are no easy solutions when it comes to retirement security. At this point in our political history, we as a nation are unwilling either to increase the government's role in providing retirement security, or to set individuals completely adrift on their own individual savings "ice floes". That means that we will have to work extremely hard to figure out how to achieve the right mix of incentives and regulation within our voluntary employer-sponsored private retirement system. The challenge will be to find approaches that will "do the job" efficiently and effectively by striking a balance between burdens and costs to employers and fairness and adequacy for employees. The Pension Rights Center looks forward to working with the Members of this Subcommittee as we move into the second stage of the Conversation on Coverage.

Thank you for inviting us to appear here today. I would be happy to answer any questions you may have.

Chairman HOUGHTON. Thanks very much, Ms. Friedman. Dr. Skinner.

STATEMENT OF JONATHAN SKINNER, PH.D., JOHN FRENCH PROFESSOR OF ECONOMICS, DARTMOUTH COLLEGE, AND PROFESSOR OF COMMUNITY AND FAMILY MEDICINE, DARTMOUTH MEDICAL SCHOOL, HANOVER, NEW HAMPSHIRE

Dr. SKINNER. Thank you, Mr. Chairman and Members of the Subcommittee. My name is Jonathan Skinner. I am a Professor of Economics at Dartmouth College.

Some years back, my colleague, Andrew Samwick and I became concerned that 401(k) plans could be exposing workers to risk and potentially lower pension benefits in comparison to what was then the status quo defined benefit plans.

At the time no one had figured out how to compare DB plans with DC plans because of the complexity in different types of both DB and DC plans. In research sponsored by the National Institute on Aging, we set out to answer this question. We used the Federal Reserve's Survey of Customer Finances from 1983 through 1998 with detailed information on hundreds of actual pension plans.

We have used these data to compare benefits for workers covered by typical DB plans in 1983, back when they were still the norm, with the benefits those same workers with the same earnings

would have received under typical 401(k) plans from the later 1990s. To my surprise, we found the reverse of what I expected.

The 401(k) plans seemed to provide higher returns with less risk than comparable DB plans. To make sure this finding was robust, we cooked the books in favor of defined benefit plans whenever possible. For example, when we simulated stock and bond returns for the 401(k) accounts, we included the dismal returns from the 1930s, but excluded the go-go years after 1990, a year when the Dow never closed above 3,000. Based on this research, we make four basic points.

First, not only do 401(k) plans from the 1990s do better than DB plans for the median worker, they also do better for the worker with minimal pension benefits. In other words, 401(k)s don't always do a great job of providing pension benefits for lower income or unlucky workers. But, DB plans, in 1983 and in 1989 were doing even worse.

Second, we were concerned about workers who neglected to contribute to 401(k)s or who spent their 401(k) balances when they changed jobs. Typically, what we found is that people who don't contribute often have an alternative DB plan. So, while they are not contributing to the 401(k), they still have some supplemental coverage. In fact, we found fewer than 4 percent of the workforce had the option of contributing to a 401(k) and didn't, and did not also have some other kind of plan.

Now, it is true that when they changed jobs, some workers spend their 401(k) balances on houses, cars and vacation travel. However, Samwick and I showed that even when workers spend a large fraction of their DC plans when they change jobs, they still do better than DB plans.

The reason is that DB plans are often not vested or eroded by inflation, meaning they are of little value to workers who change jobs. At least under 401(k) plans workers get to spend their money on things they want, like boats and houses. A third concern is that 401(k)s pay large lump sums at retirement to unsophisticated investors who may spend their money too quickly. Most retirees move their assets into IRAs, but I would like to see more default options or even requirements available for retirees such as annuities to ensure pension payments for the widows 30 years out.

Fourth, the Enron debacle has focused attention on what is the most serious charge against 401(k) plans, that they are just too risky for use in retirement planning.

Our simulations did not consider risks from employee stock ownership plans directly. I will return to this issue below. What we did consider was risks from stock market fluctuations, extreme portfolio choices and low rates of contributions. As mentioned above, even with all of these risks, the 401(k) plan still largely dominated DB plans.

The intuition is straightforward. Promotions, bonuses or poor health for the worker or her family can have profound effects on earnings in the last 5 years of service, the years that often weigh most heavily in many DB benefit formulas.

For a worker at age 35, that is one roll of the dice. By contrast, the typical 401(k) plan collects a percentage of salary over the worker's entire career. While the stock market often does take one

step back, as it has in recent years, it also tends to take two steps forward. So, on average, stocks through 2002 are still doing pretty well.

While a portfolio of stocks is a good investment, a portfolio of 95 percent Enron stocks is not. It is critical to develop stricter rules to regulation investment in company stock. It is important not to throw out the proverbial baby with the bath water. A well-designed 401(k) plan with appropriate restrictions on company stock ownership and provisions for rolling assets into annuities at retirement can and should play an important role in improving workers' financial security.

[The prepared statement of Dr. Skinner follows:]

Statement of Jonathan Skinner, Ph.D., John French Professor of Economics, Dartmouth College, and Professor of Community and Family Medicine, Dartmouth Medical School, Hanover, New Hampshire

My name is Jonathan Skinner, and I am the John French Professor of Economics at Dartmouth College in Hanover, NH. As is well understood, there has been a dramatic shift during the last several decades away from defined benefit (DB) towards defined contribution (DC) pension plan, most notably 401(k) plans. Has the shift toward 401(k) plans enhanced or detracted from American workers' financial security at retirement? In my comments below, I will focus on four major criticisms of DC and 401(k) plans that seem to suggest that future retirement security of current American workers could be jeopardized by this trend:

- Compared to DB plans, 401(k) plans cannot provide a comfortable pension at retirement, even when workers are contributing the recommended fraction of their salary.
- Many workers do not contribute even the recommended amounts, or eschew contributing altogether. When they switch jobs, they spend their 401(k) assets on houses, boats, or travel.
- Defined contribution plans paying out lump sums at retirement can be spent down quickly by unsophisticated retirees, rather than providing a fixed annual income (or annuity), as in defined benefit plans.
- The Enron debacle has focused attention on what is perhaps the most serious charge against 401(k) plans—that they are just too risky for use in retirement planning. The risks come not simply from Employee Stock Ownership Plans (ESOPs), but also from uniformed or overly aggressive investment choices, or just weak overall stock market and bond returns.

In a research project, funded in part by the National Institute on Aging, Andrew Samwick of Dartmouth College and I have considered each of these four concerns.[1] A systematic analysis of DB and DC plans has proven difficult in the past because of the varying characteristics of DB plans across firms, and varying contribution rates, matching plans, and investment decisions for workers in DC plans, again across the universe of firms offering such plans. This variability has made it difficult to generalize about "typical" DC or DB plans. Comparisons are further complicated by the continued evolution of both DB and DC plans during the past several decades.

We addressed this shortcoming by using data from the Federal Reserve Board of Governors' *Surveys of Consumer Finances* (SCF) from 1983 to 1998, and, in particular, the Pension Provider Surveys (PPS) that accompanied the 1983 and 1989 SCFs. The Surveys asked detailed information about family assets, income, 401(k) contributions, and demographic information, while the pension supplements provided information about nearly one thousand pension plans in 1983, and about half that number in 1989. For each survey respondent who was covered by a pension, an attempt was made to obtain the summary plan descriptions from the employer or union. These descriptions were then coded into computer software by the Survey Research Center at the University of Michigan. We used a substantially enhanced

[1] "How Will Defined Contribution Pension Plans Affect Retirement Income?", Dartmouth College (September 2001). http://www.dartmouth.edu/samwick/dbdc200110.pdf. Also see our paper "Abandoning the Nest Egg? 401(k) Plans and Inadequate Pension Saving." in Sylvester J. Schieber and John B. Shoven (eds.) *Public Policy Toward Pensions*. Cambridge: MIT Press, 1997, 197–217.

version of this software to compute pension entitlements. The detailed information has been merged with more recent data from the SCF on characteristics of 401(k) through 1998.

Briefly, Samwick and I found that 401(k) plans are not the ticking time bomb that many fear. If some 401(k) plans do not provide adequately for retirement, then neither did many DB plans. These findings do not depend on the extraordinary gains in equity markets during the 1990s because in our analysis, we *excluded* all equity returns after 1990, a year in which the Dow Jones Industrial Average never closed above 3000. The result is robust to lower simulated equity rates of return, to job mobility where workers "spend down" some part of their balances, and to the presence of workers contributing little or nothing to their accounts.

To provide a flavor for the findings of our research, I consider each of the four criticisms of DC plans in more detail.

1. Compared to DB plans, DC plans cannot provide for a comfortable retirement pension

There are a number of reasons why similar workers may receive different pension benefits at retirement beyond the simple reason that one worker has a DB plan and the other a DC plan. Individual workers may get different pension benefits from the *same* pension plan because of different earnings, asset allocation, or investment returns over their lifetime. Within DB plans, there is remarkable variability in the nature of plans across firms, in particular with regard to how benefits are "backloaded" with respect to earnings in the final 3 or 5 years of service. To capture this variability, we simulated a wide variety of different worker earning "histories" through age 62. In other words, we created a group of nearly 40,000 synthetic "workers" with complete earnings histories, and asked how this group of workers would have fared over their lifetime with the set of defined benefit plans available in 1983. Then we took the *same* synthetic "workers" with the *same* earning histories and provided for them randomly chosen 401(k) plans from the universe of plans offered in 1995 as well as in other years. These 401(k) plans are also subject to risk from stock and bond returns; this was done by randomly assigning historical rates of return from stocks and bonds during the 1900–1990 period. Thus it was possible for some 401(k) enrollees to experience the dismal stock rates of return from 1932 and 1933 multiple times during their employment. Summary information about our results is presented in Table 1, with all values expressed in $1995 dollars, and time trends are shown graphically for 401(k) plans in other years (1992, 1998) for the median worker in Figure 1.

In the first column of Table 1, mean 1983 DB pension benefits are $13,917, in contrast to the mean expected annuitized annual benefits of $30,880 for typical 1995 401(k) plans in Column 2. Recall that these expected DB and 401(k) pension benefits are for workers with *identical* earnings histories, and do not reflect the fact that earnings were higher in 1995 than in 1983. Median pension benefits for DB plans are $9,227 while median pension benefits for 401(k) plans are $12,694. Even among those with the very worst pension benefits—at the 10th percentile—401(k) benefits, $1,890, are higher than those for the DB plans, $1,638. In short, while 401(k) plans do not provide large pension benefits for the bottom 10th percentile of the working population because of low earnings, poor stock returns, or low contribution rates, so also does the bottom 10th percentile of DB pensions provide minimal benefits.[2] By contrast, 401(k) plans provided far more generous retirement benefits for the vast majority of workers. The 1989 DB pension benefits are on average more generous, perhaps because of the attrition of weaker DB plans during this period, but even with these more generous benefits, the universe of 1995 401(k) plans still dominates (see Samwick and Skinner, 2001, op. cit., Table 4B).

In many respects, the most generous plans are those that combine both DB and DC plans, as shown in Columns 3 and 4. Replacing combined DB and DC plans with just 401(k) plans results (not surprisingly) in a small average decline, and a larger median decline, in overall benefits. For these workers, 401(k) plans were used to supplement existing DB plans.

Figure 1 shows the secular change in the generosity for the median worker in both DB, DC, and 401(k) plans. (Non-401(k) DC plans tended to be more generous than just 401(k) plans.) Median expected payments from DB plans rose between 1983 and 1989, as noted above. Other researchers have not found increased gen-

[2] These very low DB benefits may reflect Social Security "offsets" in which the DB payment is reduced dollar-for-dollar as Social Security monthly benefits rise.

erosity in DB plans since 1989, however.[3] At the same time, the average expected generosity of 401(k) plans has been increasing through the 1990s, because of both higher contribution rates by participants and a larger share of investments in equity rather than in bonds.

To return to the first criticism of DC plans: we cannot say whether they will provide an "adequate" level of retirement security for workers in the future. But as Table 1 shows, the typical DC plan is expected to yield a higher return than the typical DB plan for a broad range of earnings and investment experiences.

2. Workers are not even contributing the recommended amounts to their DC plans, and when they change jobs, they spend down the accumulated 401(k) assets on houses, boats, or vacations.

This combination of low contribution rates and spent pension balances when workers change jobs would appear to predict serious problems for the future of American Workers. In 1993, Myron Mintz, chair of the Pension Benefit Guaranty Corporation (PBGC) stated "A whole generation of people are going to wake up years from now and say, 'God, I wish I had known when I was 32 that I should have been putting this money in."[4]

It's true that some workers do not roll over their DC plan balances when they move, but instead spend them on houses, cars, or vacation travel, particularly when the balances are small. However, rollover rates are considerably higher when the amount of the balance is large. Furthermore, Andrew Samwick and I show that even when workers spend a large fraction of their DC plans when they change jobs, they still do as well or better than DB plans. The reason is that DB plans often have vesting provisions, are not adjusted for inflation, or are tied to the last few years of work, meaning that they are worth little or nothing to workers who change jobs. At least under DC plans, workers get to spend their money on things they want to, rather than having it revert back to the employer entirely.

What about workers who neglect to contribute to 401(k)s altogether? It is true that a large number of workers fail to contribute to their 401(k) plans. However, the ones who fail to contribute typically have an alternative plan, such as a DB pension; the 401(k) is simply a supplemental plan. In a related study, we estimated that between 2–4% of all workers are offered 401(k) plans to which they fail to contribute, and have no alternative pension plan. By contrast, nearly half of all workers during the period of analysis did not even have the option of a pension, since their employers offer no pension coverage.[5]

To sum up, it may be true that some employees with the option to save through defined contribution plans may not be saving enough for retirement; pension benefits in the bottom two deciles are very low. But as we have shown, defined benefit plans also fell short at providing enough for retirement; on net, it appears that DC plans may do a better job particularly with regard to workers who switch from job to job.

3. Defined Contribution plans typically pay benefits as lump sum disbursements at retirement rather than providing annuitization.

One concern with lump sum disbursements is that they may be invested poorly by the recipient, or spent too quickly particularly if the recipient (or spouse) lives for an unusually long time. By contrast, DB plans typically pay benefits as an annuity that insures the recipient against variation in longevity and prevent the recipients from spending their wealth "too" quickly. One option for retirees with large lump-sum payments is to roll them into Individual Retirement Accounts (IRAs). This approach continues to defer tax payments and allows the individual to continue to accumulate (if they wish) until age 70 ½, at which point beneficiaries must withdraw according to an actuarial schedule. While such an approach does not provide an annuity in the way that DB pensions do (it is still possible to run down one's IRA account), it allows for smoothing out the 401(k) assets over time. Alternatively, retirees could put the (after-tax) 401(k) dollars directly into a private annuity. I am

[3] Gustman, Alan L., Isha Archer, Mariam Malik, and Toinu Reeves. "Pension Changes from 1990 to 1995 Based on Data from Watson Wyatt Reports on Pensions for the Largest Fifty Firms," mimeo, Dartmouth College (1998).

[4] Vise, David A. "A Pensionless Future? Workers at Risk as Firms Abandon Plans." *The Washington Post*. May 13, 1993, Section A, p. 1.

[5] Samwick and Skinner, 1997, op. cit. Of course, this does not mean that only half of workers will ever have pensions; indeed by the time they are close to retiring, nearly two-thirds of households have some accumulated pension wealth (Gustman, Alan L., Olivia S. Mitchell, Andrew A. Samwick, and Thomas L. Steinmeier, "Pension and Social Security Wealth in the Health and Retirement Study," in J.P. Smith and R.J. Willis, eds., Wealth, Work, and Health: Innovations in Measurement in the Social Sciences. University of Michigan Press, 1999.)

somewhat concerned about the lack of annuitization for households with large DC pension balances, particularly with regard to benefits for widows who may outlive the household's assets. Annuitization could therefore be encouraged through the use of default provisions to roll a fraction of DC balances into annuities.

4. Defined contribution and 401(k) plans force workers to face too much uncertainty regarding their pension benefits

There are a variety of risks facing workers with 401(k) pension plans. In Samwick and Skinner (2001, op. cit.) we considered several sources of risk: low overall stock and bond returns, inadequate contribution rates, and portfolios that were 100% in stocks or 100% in bonds. That study did not consider the problem of employee stock option plans, or ESOPs, an issue to which we return below. As shown in the simulation model reported in Table 1, we found that even with this investment risk, 401(k) plans in 1995 were no more risky than DB plans in 1983, and in fact provided greater pension security for nearly every retiree.

The result may appear surprising, but the intuition is straightforward. There are two sources of uncertainty; stock market returns, and the worker's future earnings. It turns out there is considerable variation in earnings, even among mature men. Promotions, bonuses, or ill health can have profound effects on earnings in the last 5 or 3 years of service, the years upon which DB plan benefits are often based. As well, for workers in their 50s, particularly for women, the burden of caring for aging parents may cause withdrawal from the labor market at a time when there is the greatest pension return to continued work experience. By contrast, the typical 401(k) plan entails annual contributions over one's entire work history, so the resulting balance reflects an average of earnings instead of the final few years. And while some years in the stock market may cause the DC balances to jump or fall by 20 percent or more, what is important is the (geometric) average of all the stock market returns over a lengthy period. Thus the risk faced by 401(k) enrollees appears to be no greater than that faced by DB enrollees.

Of course, recent history tells us that there are many other reasons why 401(k) pension plans can yield very poor returns. Even before Enron, 10,000 employees of Carter-Hawley-Hale were required to put their 401(k) money into company stock; the company later declared bankruptcy.[6] Similarly, when Color Tile declared bankruptcy in the mid-1990s, workers found themselves out of a job and without pension benefits; one disgruntled Color Tile worker commented "I would never join a 401(k) plan again. "[7] As well, unethical or uninformed employers may create "malformed" 401(k) plans with "too few choices, arbitrarily set contribution limits, hidden fees, and other traits that can, . . . at worst, seriously hobble workers' efforts to prepare for retirement."[8] Finally, there is a vast reservoir of employee ignorance about how to direct their self-directed pension funds. Based on a survey conducted by Towers Perrin, one third of respondents thought there was no risk in investing in bonds, (despite the sensitivity of bond prices to nominal interest rate changes), while 40 percent of those in a self-directed saving plan did not know how their pension assets were invested. These shortcomings are not intrinsic to 401(k) plans themselves, however. They are the consequence of imprudently administered 401(k) plans that leave the worker uneducated and with poor options.

Policy Implications and Conclusions

I have drawn on recent research with Andrew Samwick to address criticisms of emerging defined contribution plans such as 401(k)s.[9] We found that DC plans certainly have their faults, but their faults are probably less severe than those found in existing DB plans. For example, we found that DC plans are expected to entail less risk and provide generally better pension benefits compared to DB plans. And while workers may spend some of their lump-sum 401(k) disbursements when they leave their jobs, at least they get to spend it on something they like. By contrast, when workers leave firms with DB plans, they either get nothing, or their pension payments beginning at age 65 will be seriously eroded by inflation.

Nonetheless, it is clear that there is a great deal of room for improvement in the design of DC pension plans, for example by improving the rollover rates for DC plans when workers switch jobs. The Economic Growth and Tax Relief Reconcili-

[6] Kahn, Virginia Munger, "The Perils of Company Stock for Retirement," *The New York Times* (March 16, 1997): Section 3, page 6.

[7] Schultz, Ellen E., "Color Tile's 401(k) Plan Runs Aground," *The Wall Street Journal* June 5, 1996, Section C, p. 1.

[8] Johnston, David Cay, "Investing it: Building a Better 401(k)," *The New York Times* (October 22, 1995): Section 3, page 1.

[9] Samwick and Skinner, 2001, op. cit.

ation Act of 2001 (EGTRRA) mandated that rolling the 401(k) to an IRA should be the default for balances of between $1,000 and $5,000, for example. While changing defaults have been shown to have important effects on individual behavior, one could strengthen this policy further by *requiring* workers to roll over at least 50 percent of their 401(k) balances in excess of $1,000 into a qualified IRA account. This compromise allows access to funds during a potentially difficult time such as unemployment, but still preserves at least half of the retirement nest egg. Another option is to encourage rolling some fraction of the 401(k) balance at retirement into a qualified annuity fund. And it goes without saying that the lack of legal enforcement leading to "malformed" pension plans with inappropriate investment choices and restrictions, and the lack of worker financial education, are the real time bombs threatening public (and legislative) perception of DC plans.

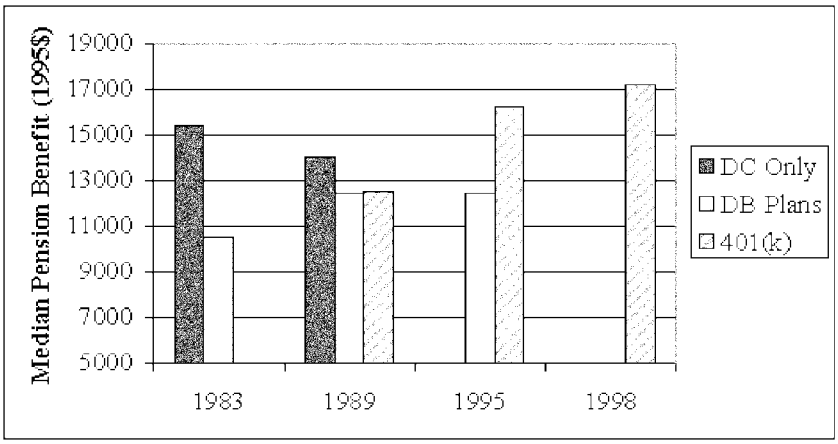
Finally, I return to a major shortcoming of the pension system more generally; namely, that even by the time workers reach their 50s, one-third of households do not have any pension wealth at all (Gustman et al, 1999, op. cit.). Thus, a real concern with pension plans is how to make it easier for firms to offer pensions to workers currently not covered by any plan. In this arena, 401(k) plans offer clear advantages over DB plans with their greater portability and fewer administrative burdens. Defined contribution pension plans may not provide *the* solution to the problem of low retirement saving among many workers. But we have argued they have the potential to play an important role to improve workers' financial security at retirement.

Table 1: Counterfactual Pension Income Distributions, 1983 Pension Provider Survey

	DB Only		DB and DC		Any DB	
	1983 PPS	1995 401(k)	1983 PPS	1995 401(k)	1983 PPS	1995 401(k)
Mean	13,917	30,880	38,135	36,905	21,412	32,745
Median	9,227	12,694	22,970	17,086	11,874	14,061
10th Percentile	1,638	1,890	4,929	3,102	2,103	2,160
90th Percentile	30,301	69,864	80,152	77,267	46,862	72,488
Standard Deviation	15,951	65,068	87,993	77,767	51,933	69,303
Obs.	22,999		10,308		33,307	

Source: Samwick and Skinner, 2001 (op. cit.)

Figure 1: Median Pension Benefits, by Type of Plan and Year



Chairman HOUGHTON. Thanks very much, Dr. Skinner. Mr. Miller.

STATEMENT OF SCOTT D. MILLER, PRINCIPAL, ACTUARIAL CONSULTING GROUP, INC., SOUTH SALEM, NEW YORK, AND PRESIDENT–ELECT, AMERICAN SOCIETY OF PENSION ACTUARIES, ARLINGTON, VIRGINIA

Mr. MILLER. Thank you, Mr. Chairman and Members of the Subcommittee. My name is Scott Miller. I am a Principal with Actuarial Consulting Group (ACG) with offices in New York and Illinois. The ACG provides actuarial, consulting and planned administrative services for retirement plans covering thousands of participants throughout the country.

I am here today to present the view of ASPA, for whom I currently serve as President-elect. The ASPA is a national organization with over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers.

The ASPA applauds this Subcommittee's leadership in examining the need to expand and reform the private retirement pension system. This need is critical with respect to encouraging plan sponsors to adopt defined benefit plans.

Unlike 401(k) plans, defined benefit plans provide a monthly annuity retirement benefit for employees. This annuity benefit is guaranteed to continue for the life of the worker and cannot be exhausted.

By contrast, benefits provided under a 401(k) plan are not guaranteed and are directly dependent on actual investment experience. This uncertainty of benefit amount is increasingly a concern as Americans live longer than ever before. Without defined benefit plans, there is a great risk that many Americans will outlive their retirement savings.

While interest in defined benefit plan coverage among employees has increased, restrictive rules have seriously impeded the ability

of large and small businesses alike to maintain defined benefit plans for their employees.

The complex rules applicable to defined benefit plans are particularly challenging to small businesses that lack the in-house expertise to manage them. We need to reform these rules so that defined benefit plans become more attractive to small businesses.

If we can revitalize defined benefit plans, both small businesses and their employees will benefit from the enhanced retirement security.

The remainder of my testimony will focus on some proposals that will help remove some of the major roadblocks faced by small businesses that want to establish defined benefit plans for their employees.

A defined benefit plan provides guaranteed benefits that are not susceptible to the whims of the stock market. Thus, it would be ideal if workers were covered by both, defined benefit plans and 401(k) plans to ensure that at least some level of retirement benefits are always protected.

Unfortunately, present law discourages the formation of defined benefit plans in combination with 401(k) plans, particularly for small businesses. For example, a defined benefit plan and a 401(k) plan cannot be maintained in a single plan. This requires two separate plans, adding thousands of dollars of unnecessary annual administrative costs.

Further, present law includes nondiscrimination, testing safe harbors. That makes it easier for employers to maintain 401(k) plans. For instance, an employer that offers a 3 percent profit-sharing contribution on behalf of employees is deemed to satisfy the complicated, nondiscrimination testing requirements applicable to 401(k) plans.

However, there is no analogous 401(k) plan safe harbor for employers who maintain a defined benefit plan, thus discouraging this combination.

The ASPA supports a proposal called the DB–K which would address these roadblocks making it easier for small businesses to offer both 401(k) and defined benefit plans to their employees. Employees are sometimes less enthusiastic about defined benefit plans because the benefits are admittedly harder to understand than 401(k) account balances.

In a traditional defined benefit plan, the benefit is typically based on final average pay and is expressed in the form of a monthly annuity that commences at retirement age.

Younger workers often find this hard to comprehend. Employees find account based plans easier to understand and thus more attractive. In response, new kinds of hybrid or cash balance plans have been developed. A cash balance plan is a defined benefit plan under which the guaranteed defined benefit is expressed as an account balance.

I want to emphasize that with small businesses, cash balance plans generally do not involve conversions since there is usually no existing defined benefit plan.

There are a number of significant legal uncertainties associated with cash balance plans because of the way benefits are accrued and distributed as compared to traditional defined benefit plans.

In general, these legal issues involve application of the accrual and benefit back loading rules, application of the age discrimination and employment act and distribution of benefits, sometimes called the "whipsaw problem."

Small businesses wanting to provide a defined benefit plan for their employees are attracted to cash balance plans since they are easier to explain to employees and the benefits tend to be more portable.

However, unlike their larger firm counterparts, small businesses cannot afford high-priced lawyers to provide legal options allowing them to sort through the various unanswered legal questions.

These legal issues need to be quickly resolved through Treasury Department regulations and through corrective legislation to the extent the Treasury Department lacks the legal authority to do so.

The ASPA greatly appreciates the Subcommittee's interest in revitalizing defined benefit plans. In addition to the proposals discussed in my testimony, ASPA is developing other proposals to promote defined benefit plan coverage and we would welcome the opportunity to discuss them with you.

The retirement security of American workers will certainly be enhanced if we can revitalize defined benefit plans and once again make them attractive to small business employers. Thank you and I would be pleased to answer any of your questions.

[The prepared statement of Mr. Miller follows:]

Statement of Scott D. Miller, Principal, Actuarial Consulting Group, Inc., South Salem, New York, and President-Elect, American Society of Pension Actuaries, Arlington, Virginia

Introduction

Thank you, Mr. Chairman and members of the subcommittee. My name is Scott Miller. I am a Principal of Actuarial Consulting Group, Inc., with offices in New York and Illinois. Actuarial Consulting Group, Inc. provides actuarial, consulting, and plan administrative services for retirement plans covering thousands of participants throughout the country. Although, many of the firm's clients are small businesses with less than 100 employees, the firm also provides retirement plan services to larger firms, including Fortune 100 companies.

I am here today to present the views of ASPA, for whom I currently serve as President-Elect. ASPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPA's membership is diverse, but united by a common dedication to the private pension system.

ASPA shares the concerns of this subcommittee, of Congress, and of America about the tragic consequences arising from the bankruptcy of Enron Corp. We applaud this subcommittee's leadership in exploring whether, and where, our nation's pension laws may need strengthening. We also commend the subcommittee for its stated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers.

The current plight of the Enron 401(k) plan participants highlights the need to expand and reform the private pension system. The need for reform is especially acute with respect to encouraging plan sponsors to adopt and provide defined benefit pension plans. Unlike 401(k) and other defined contribution plans, defined benefit pension plans provide a defined monthly annuity retirement benefit for employees. This annuity benefit is guaranteed to continue for the life of the worker and cannot be exhausted. On the other hand, benefits provided under a 401(k) or other defined contribution plan are not guaranteed and are directly dependent on actual investment experience. Therefore, the level of benefits and how long they can con-

tinue to be paid is unknown to the retiree. As Americans live longer then ever before, this uncertainty regarding the actual amount of retirement benefits is increasingly a concern.[1] Without defined benefit pension plans, there is a great risk that many Americans will outlive their retirement savings.

Further, and very importantly, in a defined benefit pension plan, it is the employer, and not the employee, that bears the risk of investing the plan assets. This means that the employer has an obligation to make sure the defined benefit pension plan is properly funded to provide the promised benefits, regardless of investment experience. Therefore, the lower the investment returns, the higher the required employer contribution. Additionally, the Pension Benefit Guaranty Corporation insures the payment of a minimum level of retirement benefits under a defined benefit pension plan should the plan sponsor's financial stability falter and they are not able to properly fund the plan.

According to a recent survey, interest in defined benefit pension plan coverage among employees has increased by 20 percent as employees find it difficult to manage their 401(k) plan accounts.[2] However, since the passage of ERISA, many restrictive and complex laws have been enacted, and complicated regulations issued, which have seriously impeded the ability of large and small businesses alike to maintain defined benefit pension plans for their employees.

The consequences of this have been dramatic, particular for small businesses. According to the Department of Labor, since 1983 the number of small business defined benefit pension plans has dropped over 70 percent. The termination of these defined benefit pension plans has occurred during a period of time when small businesses are employing an ever-increasing percentage of the U.S. workforce. Today, small businesses employ half of the nation's workers, and have created more than half of the new jobs in recent years. However, according to the Bureau of Labor Statistics, small business employees are only half as likely to be covered by any retirement plan, and only one-fifth as likely to be covered by a defined benefit pension plan, than their counterparts working at larger firms.

This disparity between small and large business employees is clearly unacceptable. Some of the most burdensome and complex rules in pension law apply to defined benefit pension plans. These rules are particularly challenging to small businesses that lack the in-house expertise to manage them. We need to reevaluate and modernize these rules so that defined benefit pension plans become more attractive to small businesses. This **can** be done while still protecting the interests of employees. If we can revitalize defined benefit pension plans, both small businesses and their employees will benefit from the enhanced retirement security.

The remainder of my testimony will focus on proposals that will help remove the major roadblocks faced by small businesses that want to establish and maintain defined benefit pension plans for their employees.

Proposals to Promote Small Business Defined Benefit Pension Plan Coverage

Facilitate Combination Defined Benefit/401(k) Plans (the "DB-K")

A defined benefit pension plan provides a guaranteed level of benefits to workers (insured by the federal government) that are not susceptible to the whims of the stock market. By contrast, benefits under a defined contribution plan, like a 401(k) plan, are dependent on investment returns—if the stock market goes down, benefits are reduced. Consequently, it would be ideal if workers were covered by both a defined benefit pension plan and a 401(k) plan to ensure that at least some retirement benefits are always protected.

Unfortunately, present law discourages the formation of defined benefit pension plans in combination with 401(k) plans, particularly for small businesses. For example, a defined benefit pension plan and a 401(k) plan cannot be maintained as a single plan with a single trust. Requiring two separate plans adds thousands of dollars of unnecessary annual administrative costs. Further, present law includes nondiscrimination testing safe harbors that make it easier for employers to maintain 401(k) plans. For instance, an employer that offers a 3 percent profit-sharing contribution on behalf of employees automatically satisfies complicated nondiscrimination testing requirement applicable to 401(k) plans. However, there is no analogous 401(k) plan safe harbor for employers who maintain a defined benefit pension plan, thus discouraging employers from offering both 401(k) and defined benefit plans.

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[1] The average life expectancy of Americans born in 1960 was 69.7 years. It has been estimated that those born in 2000 will live for an average of 76.4 years. U.S. National Center for Health Statistics, *Vital Statistics of the United States.*

[2] PlanSponsor.com (June 5, 2002).

In addition, special corporate deduction limits are triggered when an employer funds both a defined benefit pension plan and a 401(k) plan. These deduction limits are often problematic for small businesses since they are based on a percentage of aggregate employee compensation and small businesses naturally have fewer employees and therefore a limited contribution level. If the small business is offering a 401(k) plan with matching contributions, a fairly typical scenario, these deduction limits greatly inhibit the ability of the small business to offer an additional defined benefit pension plan.

Finally, present law also does not permit employees to earn higher defined benefit accruals in the form of matching contributions, that relate to the amount an employee contributes to a 401(k) plan. If it did, this would allow employers to reward employees who save for retirement on their own behalf, with greater employer guaranteed defined benefits.

ASPA supports a proposal, called the "DB–K", which would address these roadblocks making it easier for small businesses to offer both 401(k) and defined benefit pension plans to their employees. Although there are several technical details which we would be happy to outline for you, in summary the DB–K proposal would accomplish four objectives:

- First, a 401(k) plan and a defined benefit pension plan could be maintained as a single plan with a single trust with reduced administrative costs.
- Second, under a new 401(k) plan safe harbor, the nondiscrimination test applicable to 401(k) plans will be satisfied if a defined benefit pension plan maintains a sufficient level of benefit (e.g., 1 percent per year final average pay plan accumulated over 20 years) that is always fully vested.
- Third, certain matching and/or profit sharing contributions under a 401(k) plan (including a 401(k) arrangement that is maintained as part of a defined benefit pension plan) would be disregarded in determining whether the special deduction limits for combined plan funding are exceeded.
- Fourth, the law would be modified to allow for defined benefit pension plans to provide higher benefit accruals for employees who take the responsibility to save, through matching benefit accruals based on the level that employees defer from their compensation.

Clarify Rules Governing Hybrid or "Cash-Balance" Plans

Employees are sometimes less enthusiastic about defined benefit pension plans because the benefits are admittedly harder to understand than 401(k) account balances. In a traditional defined benefit pension plan, the benefit is typically based on final average pay and is expressed in the form of a monthly annuity that commences at retirement age, which is often far off into the future. Employees find account-based plans, that track current account values, easier to understand and thus more attractive.

In response, new kinds of hybrid or "cash balance" plans have been developed. A cash balance plan is a defined benefit pension plan under which the promised benefit is expressed as a hypothetical account balance. The account is "hypothetical" because there is no actual account established on behalf of the participant. Nonetheless, the participant is entitled to the benefit provided in the account. This account is really just a bookkeeping notion. An eligible employee accrues a benefit by earning a right to a hypothetical contribution (usually a percentage of compensation) for each year of participation, which is credited to the employee's account. The hypothetical account balance is also increased each year by a guaranteed interest rate. When benefits are distributed from a cash balance plan, the hypothetical account balance is converted into the actuarial equivalent of the form of annuity or installment benefit payable under the plan (or chosen by the participant, if the plan provides multiple payment options). These options could include a single lump sum distribution.

There are a number of significant legal uncertainties associated with cash balance plans because of the way benefits are accrued and distributed as compared to traditional defined benefit pension plans. Although these issues are technical in nature, they are critical to the legal operation of the plan. In general, these legal issues involve application of the accrual and benefit backloading rules to cash balance plans, application of the Age Discrimination and Employment Act to cash balance plans, and distribution of the benefit under a cash balance plan (the so-called "whipsaw" problem).

There has also been some controversy when employers, generally larger employers, have converted traditional defined benefit pension plans to cash balance plans. However, conversions are generally not an issue for small businesses considering a cash balance plan, since there is often no preexisting defined benefit pension plan.

Small businesses wanting to provide a defined benefit pension plan for their employees are attracted to cash balance plans since they are easier to explain to employees and the benefits tend to be more portable. Unfortunately, most small businesses are reluctant to establish these defined benefit pension plans because of the legal uncertainties. Unlike their larger firm counterparts, small businesses cannot afford high-priced lawyers to provide legal opinions allowing them to sort through the various unanswered questions. Small businesses will not provide these valuable defined benefits for their employees unless these legal uncertainties are resolved in a clear and unambiguous way. It is critical that these issues are quickly resolved through Treasury regulations, or through corrective legislation to the extent Treasury lacks the legal authority to do so.

Modernize Actuarial Assumptions

Current laws with regard to actuarial assumptions required for defined benefit funding and benefit calculations are outdated. For example, current rules require the use of 30-year Treasury bond interest rates when calculating the current liability of the plan. Last October the Department of Treasury announced that it was no longer issuing 30-year Treasury bonds. However, defined benefit pension plan funding calculations are still based on these rates, which is now artificially low since no new bonds are being issued. Use of this artificially low 30-year Treasury bond rate has contributed to the unnecessary overfunding of many larger defined benefit pension plans, making them less attractive to these employers. Fortunately, this year Congress enacted a temporary solution that will last through 2003. However, a permanent replacement interest rate benchmark must be found soon to address employer's uncertainties about future funding obligations.

The fluctuations in the 30-year Treasury bond rate have also had a negative impact on small business defined benefit pension plans. Under current law, the 30-year Treasury bond rate is also used for calculating the defined benefit pension plan limit under IRC Section 415(b) for lump sum distributions. A reduction in the rate yields a higher limit, putting added funding pressure on plans, especially smaller plans that suddenly are required to make higher than anticipated lump sum payments to participants. This unanticipated increase can amount to tens of thousands of dollars, simply due to a minor change in the monthly interest rate ¼ of a percent). A small business may not be able to afford such uncertainty. These consistently changing interest rates cause required funding levels to often fluctuate significantly making financial planning for small businesses difficult.

Prior to 1994, this problem did not exist. A fixed 5 percent interest rate was used for calculating the defined benefit pension plan limit under IRC Section 415(b) for lump sum distributions. ASPA believes that we should return to this benchmark to give small businesses more stability with respect to plan funding requirements. This would also give small business owners, who are often subject to the 415 limit, a precise measure of what their benefit will be at retirement. Because of present law, you cannot tell many small business owners exactly what their benefit will be at retirement, because an interest rate fluctuation at the time of retirement could significantly affect their benefit amount. This uncertainty makes the defined benefit pension plan less attractive to the small business owner when deciding whether or not to adopt a plan for herself and her employees.

Allow for Flexible Funding of Defined Benefit Pension Plans

Employers, particularly small employers, are also often reluctant to adopt defined benefit pension plans because of mandatory funding requirements. These mandatory funding requirements are designed to ensure that defined benefit pension plans are adequately funded. They require that employers contribute at least a minimum amount to the plan each year—a minimum funding requirement. Employers, particularly small businesses, are often worried that they may not be able to afford the minimum funding requirements if there is a business downturn. Unfortunately, present law also limits the maximum amount employers can contribute to the plan in any year, and thus prevents prospering employers from contributing an additional amount when the business is doing well, and can afford it, to cover a potential future business downturn. This presents an unacceptable risk to many small businesses whose revenue can be dramatically affected by an economic recession in a manner disproportionately greater than larger firms. Ironically, the operation of current law funding requirements generally require higher minimum funding requirements during an economic downturn and restrict funding during a stronger economy.

ASPA believes that an employer maintaining a defined benefit pension plan should be permitted to contribute an additional amount (within reasonable limits) during an economic upswing to prepare for the potential of a future economic down-

turn. This could be allowed, for example, once every five years. Under such a proposal, the total amount contributed to the plan over the given period would not change. It would simply allow the small business to make larger contributions in the years the additional financial resources are available.

Conclusion

ASPA greatly appreciates this subcommittee's interest in revitalizing defined benefit pension plans. In addition to the proposals discussed in my testimony, ASPA is developing other proposals to promote defined benefit pension plan coverage and we would welcome the opportunity to discuss them with you. The retirement security of American workers will certainly be enhanced if we can revitalize defined benefit pension plans and once again make them attractive to small business employers.

Thank you, Mr. Chairman and members of the subcommittee, for this opportunity to make our views known. I would be pleased to answer any questions you may have.

Chairman HOUGHTON. Well, thanks very much, Mr. Miller.

Mr. Beilke.

STATEMENT OF MARK BEILKE, DIRECTOR, EMPLOYEE BENEFITS RESEARCH, MILLIMAN USA, VIENNA, VIRGINIA, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL

Mr. BEILKE. Mr. Chairman, thank you very much for the opportunity to appear today. Milliman USA is a consulting and actuarial firm with more than 5,000 employee benefit clients of all sizes, most of which sponsor defined benefit plans. I am appearing today on behalf of the American Benefits Council where Milliman serves on the Board of Directors.

Mr. Chairman, other witnesses today have detailed the poor health of our defined benefit system. A key factor is that throughout the 1980s and early 1990s frequent changes were made to the statutes governing defined benefit plans. The result was that administration of these plans has become increasingly expensive and complicated.

During the same period, Congress repeatedly reduced the benefits that could be earned through defined benefit plans, undermining the commitment to these voluntary plans by key decision makers.

Representatives Portman and Cardin have led the effort to establish a more supportive environment for defined benefit plans. Their work culminated in the landmark reforms enacted in the 2001 tax law.

In the Council's view, making these pension changes permanent, something the House may consider as soon as tomorrow, is one of the most important steps Congress can take to encourage defined benefit plans.

To stem defined benefit plan terminations, Congress needs to correct the artificially inflated liabilities that employers face as a result of the demise of the 30-year Treasury bond. Under current law, defined benefit plan sponsors are required to use 30-year Treasury bond rates for a variety of calculations under the plan. Yet the Treasury Department's buy back and discontinued issuance of 30-year Treasury bonds has driven these rates to a level significantly below other conservative long-term bond rates.

The result has been an artificial inflation in pension liabilities. This produces a very substantial increase in the pension contributions and PBGC premiums employers must pay. These unreasonably inflated liabilities play an increasing role in employers' decisions to abandoned defined benefit pensions.

Led by Representatives Johnson of Texas, Portman, Cardin, and Pomeroy, Congress has already moved to address these very serious problems by enacting short-term pension funding and premium relief and additional short-term relief is contained in the House-passed Pension Security Act.

Next, it will be imperative for Congress to enact permanent pension interest rate reform. This will involve selection of a new long-term interest rate, not only for pension funding and premium purposes, but for all pension calculations currently dependent on the 30-year rate, including the valuation of maximum benefits and lump sums payable from defined benefit plans.

Any change affecting lump sums will, of course, need to include significant transition relief for employees nearing retirement age.

The Council is committed to working with Congress and with groups from across the ideological spectrum to craft a permanent pension interest rate reform so necessary for defined benefit plans to remain viable.

One bright spot in the defined benefit landscape has been the development of cash balance and other hybrid defined benefit plans. While these plans offer traditional defined benefit advantages such as employer funding and risk bearing, plus Federal guarantees, they do so in an individual account form, which enhances portability and understandability.

Their benefit accrual pattern is not as backloaded as traditional plans, producing higher pension benefits for employees who switch jobs several times during their careers.

As a result, cash balance plans are often a better fit for the retirement needs of today's mobile workforce.

Unfortunately, the laws and regulations applicable to defined benefit plans have not been updated to reflect the development of cash balance plans. The relevant Federal agencies have been engaged for several years in an effort to resolve the uncertainties caused by the awkward application of the traditional rules to these plans.

This effort is apparently nearing fruition and proposed guidance on some of these questions is eagerly awaited by the benefits community. The Council believes that whether through regulatory guidance or statutory clarification, it is imperative that we resolve the remaining uncertainties surrounding cash balance plans. These plans are the only source of vitality in our defined benefit system today and are the most effective way to preserve defined benefit plan advantages in a manner that meets the needs of a mobile workforce.

Our policy framework should encourage these plans through clear rules that acknowledge their unique design features and we hope to work with Congress to achieve this result.

Mr. Chairman, the Council feels strongly that we must ensure that both traditional and cash balance defined benefit plans remain

viable choices for employers so the companies can select the pension design most suited to the needs and wishes of their workforce.

Defined benefit plans offer unique advantages for employees, but without prompt action by Congress we fear these plans will increasingly disappear from the American pension landscape. Thank you, Mr. Chairman.

[The prepared statement of Mr. Beilke follows:]

Statement of Mark Beilke, Director, Employee Benefits Research, Milliman USA, Vienna, Virginia, on behalf of the American Benefits Council

Chairman Houghton, Ranking Member Coyne, thank you very much for the opportunity to appear before you today on this critically important topic. I am Mark Beilke, Director of Employee Benefits Research for Milliman USA. Milliman USA is a firm of consultants and actuaries with more than 30 offices in the U.S., more than 1,600 employees, and over 5,000 employee benefits clients, most of which sponsor defined benefit pension plans. I am appearing today on behalf of the American Benefits Council, where Milliman serves on the board of directors. The American Benefits Council (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.

Background on Defined Benefit Plans

Mr. Chairman, I want to thank you for calling this hearing to examine the state of our nation's defined benefit pension system. Such an examination is urgently needed. While the private-sector defined benefit system helps millions of Americans achieve retirement income security, it is not a system in good health. The total number of defined benefit plans has decreased from a high of 170,000 in 1985 to 59,000 in 1997 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today.[1] There has been a corresponding decline in the percentage of American workers with a defined benefit plan as their primary retirement plan from 38% in 1980 to 21% in 1997. Looking at the decline in defined benefit plans from one year to the next makes this unfortunate downward trend all the more stark. The Pension Benefit Guaranty Corporation (PBGC) reports that it insured 39,882 defined benefit plans in 1999 but only 38,082 plans just one year later in 2000. This is a decrease of almost two thousand defined benefit plans in a single year. Furthermore, based on what we are seeing throughout my firm, there is more plan termination activity in 2002 that we have seen in recent years.

These numbers are particularly sobering because defined benefit plans offer a number of features that are effective in meeting employee needs—benefits are funded by the employer (and do not typically depend upon employees making their own contributions to the plan), employers bear the investment risk in ensuring that earned benefits are paid, benefits are guaranteed by the federal government through the PBGC, and benefits are offered in annuity form. The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances), as well as the national retirement policy discussions spurred by the bankruptcy of the Enron Corporation, have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

So, with these advantages for employees, what has led to the ill-health of the defined benefit system? Several factors have played a role. First, the statutory and regulatory landscape has not been friendly to defined benefit plans and the companies that sponsor them. Throughout the 1980's and early 1990's, frequent changes were made to the statutes and regulations governing defined benefit pensions, often in the name of promoting pension "fairness." Yet the result was that these plans became increasingly expensive and complicated to administer and the plan design flexibility so important to employers was impaired. During the same period, and motivated by a desire to raise federal revenue, Congress repeatedly reduced the benefits that could be earned and paid from defined benefit plans, undermining the per-

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

sonal commitment to these voluntary plans by senior management and other key decision-makers.

Defined benefit plans also require very significant—and often unpredictable—financial commitments from employers, something that many companies found more difficult to maintain in light of intense business competition from domestic and international competitors, many of which did not offer defined benefit plans and so did not have the corresponding pension expense. In addition, employees have not tended to place great value on defined benefit pension benefits offered by employers, preferring "shorter-horizon" and more visible benefits such as 401(k) and other defined contribution plans, stock option or stock purchase programs, health insurance and cafeteria plans. So ironically, while defined benefit plans have been complicated for employers to administer and expensive for them to maintain, they have not resulted in a significant increase in employee satisfaction, which is one of the core reasons for an employer to offer a benefit program in the first place.[2]

The Pension Achievements Contained in the 2001 Tax Law

The Council is very gratified that in recent years Congress has recognized these disturbing trends and has begun to establish a more supportive policy environment for defined benefit pensions. This change of direction was initiated by Representatives Rob Portman and Ben Cardin and began in earnest with passage of the Portman/Cardin pension reforms contained in the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997.

Representatives Portman and Cardin continued their efforts with the Comprehensive Retirement Security and Pension Reform Act (H.R. 1102 in the 106th Congress; H.R. 10 in the 107th Congress), which was ultimately enacted as part of the 2001 tax law. This legislation contained a number of very positive changes to the rules governing defined benefit plans. Correcting a series of past revenue-driven restrictions enacted by Congress, the Portman/Cardin legislation repealed an artificially low cap on pension funding that had complicated pension budgeting and financing. It also increased the benefits that can be earned under—and paid from—qualified defined benefit pension plans so that these plans remain an attractive vehicle for employers to sponsor in our voluntary pension system. The Portman/Cardin legislation also simplified a number of the most complex rules applicable to defined benefit plans, making these plans somewhat easier to administer, particularly in the context of mergers and acquisitions.

Mr. Chairman, you played a leading role in advancing these pension reforms through the Ways & Means Committee and many members of this Subcommittee worked to see these reforms enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. Thank you for these efforts, and thank you, of course, to Representatives Portman and Cardin for their leadership in drafting and advancing a series of reforms that have put our nation's defined benefit pension policy on a new and more productive course.

Making the 2001 Pension Reforms Permanent

We understand that this week the House of Representatives will consider legislation introduced by Representatives Portman and Cardin—H.R. 4931, the Retirement Savings Security Act of 2002—which will make the pension changes of the 2001 tax law permanent. In the Council's view, this is one of the most important steps Congress can take to continue to encourage and support defined benefit pension plans. Sound pension policy depends upon truly long-range planning and budgeting, for both employees and employers, and this is difficult to achieve given that all of last year's positive reforms are scheduled to evaporate come 2011. Consistency and supportiveness have too often been lacking in our nation's policy toward defined benefit pension plans, but by making the 2001 pension changes permanent Congress can realize these goals and help to restore the health of our nation's defined benefit system.

Unfinished Pension Reforms from the Portman/Cardin Legislation

Additional changes to our pension laws that would aid defined benefit pensions were contained in the Portman/Cardin pension legislation approved by the House (H.R. 10) but were not enacted as part of the final 2001 tax law due to anticipated application of the Byrd Rule in the Senate. Representatives Portman and Cardin have gathered these reforms in H.R. 3918, the Pension Improvement Act of 2002 and nearly all of these reforms were included in the Pension Security Act (H.R. 3762) passed by the House of Representatives on April 11, 2002.

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[2] Employee preference for account-based and more portable benefits has been a prime factor in the development of hybrid defined benefit plans, which are discussed below.

These reforms would make defined benefit plans a more attractive vehicle for small employers through pension insurance premium relief and simplified reporting. They would create fairness for defined benefit plan sponsors by allowing the PBGC to pay interest on premium overpayments. Finally, they would help to simplify and rationalize defined benefit plan administration through a number of regulatory reforms, such as providing a limited safety valve from mechanical testing rules, encouraging electronic dissemination of plan documents, and modernizing plan notice regimes.

The provision providing for a limited safety valve from the mechanical pension testing rules has come under criticism from some quarters. The Council believes that this criticism is unfounded and that the safety valve provision is needed to ensure the rationality of the rules governing our pension system. The provision has been thoroughly vetted and debated and has been approved by the House of Representatives five times, often by overwhelming margins. The provision merely provides a limited safety valve so that fair pension plans that may be tripped up by mechanical testing rules can, under limited circumstances, demonstrate the equity of their plan to Treasury Department officials.

We encourage you to enact these important remaining items from the Portman/Cardin pension legislation this year in order to take another important step to support and encourage defined benefit pensions.

Pension Interest Rate Reform

Another area in which Congress has been tremendously helpful in recent months is in addressing the very serious repercussions for defined benefit pension plans of the decline in 30-year Treasury bond rates.[3] If one puts aside the necessary follow-up work to enact the unfinished Portman/Cardin pension changes and to make the 2001 pension reforms permanent, clearly the action most urgently needed to stem the increasing number of defined benefit plan terminations is for Congress to enact permanent and comprehensive reform of the interest rates used for pension calculations. To highlight the urgency of this task, the Council has recently learned of several large employers that have concluded they must freeze their defined benefit plans. In each instance, the financial ramifications stemming from the low 30-year Treasury bond rates has been a primary factor.

Under current law, employers that sponsor defined benefit pension plans are required to use 30-year Treasury bond rates for a wide variety of pension calculations. Yet the Treasury Department's buyback program and subsequent discontinuation of the 30-year bond has driven rates on these bonds to a level significantly below other conservative long-term bond rates. The result has been an artificial inflation in pension liabilities, often by more than 20 percent. As a result of these inflated liabilities, employers confronted inflated required pension contributions and inflated variable premium payments to the PBGC. Due to the nature of the pension funding rules, a number of employers faced dramatic increases in their pension funding obligations. I personally saw plans that had been overfunded for several years, requiring no cash contributions, which required substantial funding. Others that had modest and predictable contribution levels in the past saw funding requirements at multiples of what had been required in recent years.

Congress recognized that these unwarranted funding and premium obligations could not have come at a worse time. Such requirements would drain away hundreds of millions of dollars at a time when employers needed all the resources they could muster to keep workers on the payroll and to make the purchases and investments necessary to return the nation to economic growth. Congress also recognized that unreasonably inflated liabilities discourage employers from maintaining strong pension programs for their employees.

To correct for these inflated liabilities, Congress included short-term pension interest rate relief in the Job Creation and Worker Assistance Act of 2002, which President Bush signed into law on March 9, 2002. This short-term relief helped to remedy the artificially inflated funding and premium obligations faced by employers for the 2002 and 2003 plan years. It did so by allowing employers to use a higher interest rate for pension purposes (120 percent of the 30-year bond rate for funding purposes and 100 percent of the 30-year bond rate for premium purposes). This relief has made a meaningful difference to employers around the nation who have seen artificial liabilities corrected and precious resources freed up for maintaining payrolls and keeping businesses strong. This helped salvage employer commitment

[3] The decline in these rates is attributable to the Treasury Department program of the last four years to buy back 30-year bonds from the public and was capped off by the outright discontinuation of the 30-year bond on October 31, 2001.

to these plans so as to ensure that employees will continue to build defined benefit pension benefits.

Four members of the Ways & Means Committee—Representatives Sam Johnson, Rob Portman, Ben Cardin and Earl Pomeroy—led the effort to secure this relief, and the Council wishes to extend its sincere appreciation for their leadership on this issue. These same Members are now working hard to apply the relief to the final 2001 payment that defined benefit plan sponsors must make by September 15, 2002 and to make a number of technical corrections to the relief provided in the stimulus legislation. These additional reforms were included in the House-passed Pension Security Act (H.R. 3762) and the Council looks forward to working with the Ways & Means Committee to identify an appropriate legislative vehicle that can carry these additional reforms to the President's desk in a timely fashion.

Once short-term relief has been achieved, the Council believes it will be imperative for Congress to turn its attention to developing and enacting *permanent* and *comprehensive* pension interest rate reform. This effort must involve selection of a substitute long-term interest rate for use by pension plans in lieu of the 30-year Treasury bond rate. The effort must also involve correction of the rate not only for pension funding and premium purposes (the areas addressed by the short-term relief) but for all pension purposes currently dependent on the 30-year rate, such as the valuation of maximum benefits and lump sums payable from defined benefit pensions.

The low 30-year Treasury bond rates have had the same inflationary effect on lump sum payments from defined benefit plans that they have had on the funding and premium obligations of these plans. In other words, the low rates have produced artificially inflated lump-sum payments to departing employees. While these inflated lump sums may appear to redound to the benefit of the affected employees, the reality is that the drain of cash from plans as a result of these artificially inflated payments has led a number of plan sponsors to freeze or terminate their defined benefit plans. This is clearly a very unfortunate result for the employees at these firms. Artificially inflated lump sums also deter employees from taking their benefit in an annuity form of payment, which would often be the preferable choice from a retirement income security and retirement policy perspective. Clearly, any change to the interest rate used for lump-sum valuation purposes will need to include significant transition relief for participants nearing retirement age, but making this change is critical to the future of defined benefit plans.

We cannot over emphasize the urgency of developing this permanent, comprehensive reform nor the degree to which achieving this reform is related to stemming the decline in defined benefit plans. The Council is committed to working with Congress and with groups from across the ideological spectrum to craft the permanent, comprehensive pension interest rate reform so necessary for defined benefit plans to remain viable.[4]

Hybrid Plan Clarification

One notable bright spot in the defined benefit plan landscape in recent years has been the development of what are known as hybrid defined benefit plans, the most common variety of which is the cash balance plan.[5] These plans have proven popular with employees and employers alike. While they offer the benefits of a traditional defined benefit plan (employer funding and risk-bearing, federal guarantees, the option of annuity benefits), they do so in an individual account form that is more easily understood and therefore more easily integrated into the employee's overall retirement planning. Cash balance plans also offer the benefit of portability since benefits can be rolled over to an employee's next workplace retirement plan or to an Individual Retirement Account. In addition, they offer a more even accrual pattern than traditional defined benefit plans (where significant benefit accruals are

[4] The Council is currently developing our recommendations regarding the appropriate permanent, comprehensive solution to the pension interest rate problem and will be pleased to share our thoughts with Congress when we complete this process.

[5] The cash balance design combines features of a traditional defined benefit pension with those of a defined contribution plan such as a 401(k), hence the term "hybrid." In a traditional defined benefit plan, an individual's pension is generally determined by a formula incorporating the employee's years of service and pay near retirement. The benefit in this traditional pension is expressed in the form of a lifetime annuity (stream of income) beginning at normal retirement age, which is typically 65. In a cash balance plan, an individual's pension is generally determined by an annual benefit credit (typically a percentage of pay) and an annual interest credit (an annual rate of interest that is specified by the plan). These benefit and interest credits are expressed as additions to an individual's cash balance account. These accounts grow over time as the benefit and interest credits accumulate and compound. Benefits in a cash balance plan are ultimately paid out in the form of a lifetime annuity or a lump sum.

dependent on long service, producing disappointing results for employees who switch jobs several times during their careers). The bottom line is that the individual accounts, portability and level accruals of cash balance plans often make these hybrid defined benefit plans a better fit for the retirement needs of today's mobile workforce than the traditional defined benefit pension.[6]

Unfortunately, the laws and regulations applicable to defined benefit plans have not been updated to reflect the development and adoption of cash balance plans over the last 15 years. These defined benefit rules were constructed entirely around the model of a traditional defined benefit plan, where the typical formula is tied to years of service and final pay and the benefit is paid in an annuity form at age 65. As a result, the rules are ill-suited to account-based cash balance plans, which have more level accruals and typically pay lump sums at whatever age employees depart. The awkward application of the traditional defined benefit rules to cash balance plans has left a number of pressing legal and compliance issues regarding these hybrid plans unresolved.

To give one example, some uncertainty exists regarding whether the value of the cash balance account constitutes the employee's accrued benefit in a cash balance plan. This is clearly what is intended under a cash balance plan such that when an employee departs they are paid the balance in their account. Yet some have argued that application of the traditional defined benefit rules yields a different result. This theory holds that, in determining an employee's lump sum distribution from a cash balance plan, the plan must project the cash balance account value forward to normal retirement age using the plan's interest crediting rate and then discount the resulting figure to a present value using the statutorily prescribed 30-year Treasury bond rate. When the plan's interest crediting rate is higher than the 30-year bond rate, this process produces an amount higher than the value of the cash balance account. This has been dubbed the "whipsaw" theory. While such a theory might appear to benefit the affected employee, the result is that employers must lower the cash balance plan's interest crediting rate for *all* employees to the low 30-year Treasury bond rate in order to avoid whipsaw, substantially impairing the growth in cash balance accounts that would result from payment and compounding at a higher interest rate.

The federal agencies with jurisdiction over defined benefit plans—led by the Treasury Department—have been engaged for several years in an effort to resolve some of these legal and compliance uncertainties. The Council understands that this effort is nearing fruition and that proposed guidance on some of these questions may be issued later this summer. Yet it appears that the regulatory guidance will not address all of the outstanding issues, and the agencies may well conclude that they do not have statutory authority to reach all of the open questions. The Council believes that, whether through regulatory guidance or statutory change, it is imperative that we resolve the remaining uncertainties surrounding cash balance plans. These plans are the only real source of vitality in our defined benefit system today and have proven themselves to be the most effective way to deliver defined benefit plan advantages and protections in a way that meets the needs of today's mobile employees. The statutory and regulatory climate should encourage these plans through clear rules that acknowledge their unique design features. Thus, we hope to work with Congress in the wake of the issuance of regulatory guidance later this year to complete the task of establishing a stable and supportive legal environment for cash balance plans.

The Next Generation of Pension Reform

With the enactment of the many positive Portman/Cardin pension reforms as part of the 2001 tax law, the Council has spent a good deal of time over the past year developing additional recommendations to further strengthen and expand the employer-sponsored retirement system. A number of these recommendations focus on ways to revitalize our defined benefit system and many of the defined benefit reforms I have already discussed today top our list of recommendations. Thus, we believe making the 2001 pension reforms permanent, enacting the unfinished Portman/Cardin pension changes, achieving permanent and comprehensive pension interest rate reform, and clarifying the rules applicable to cash balance plans are

[6] Congress devoted significant attention to conversions from traditional defined benefit plans to cash balance plans during the 106th Congress. It was understandably concerned about the information employees received regarding these conversions and how certain, discrete groups of workers were affected by the change in plan design. These concerns led to enactment of an expanded notice requirement as part of the 2001 tax law, which will ensure that all employees receive the information they need to understand these conversions and the effect on their pension benefits.

the most important steps Congress can take to improve the health of our defined benefit system.

Yet there are other reforms that the Council believes would help strengthen defined benefit pensions, and let me share a few with you today.

- First, the Council believes it is appropriate to consider reducing the per participant pension insurance premiums that employer sponsors of defined benefit plans pay to the PBGC. The premium discounts contained in the original Portman/Cardin bill and included in recent House-passed pension legislation (H.R. 3762) benefit only small employers or those firms that have never had a defined benefit plan. We believe modest premium relief would also be appropriate for employers to help restrain this significant cost that accompanies sponsorship of a defined benefit pension.
- Second, the Council believes Congress should help to make defined benefit pension benefits a more useful mechanism for the financing of retiree medical coverage. Pension benefits are often used to meet health costs in retirement and we believe certain tax changes would help employees do this more efficiently. At many companies today, employees are asked to bear a share of the cost of retiree medical coverage. Yet if these employees are receiving a pension benefit and wish to pay their retiree medical premium with these funds, the position of the Internal Revenue Service appears to be that these workers must pay tax on the pension benefit and then pay the premium with after-tax dollars. We recommend that Congress allow employees to direct the appropriate portion of these pension payments to pay retiree medical premiums on a pre-tax basis (as active employees may do with salary to pay health premiums). This will allow employees to pay these premiums with pre-tax dollars, helping to alleviate one of the primary financial pressures faced by many older Americans.
- Third, the Council recommends adoption of legislation introduced by Representatives Roy Blunt and Earl Pomeroy (H.R. 3012), which allows employers to "pick up" employee contributions to a contributory defined benefit plan so that these employee contributions may be treated as pre-tax contributions. This "pick-up" pre-tax treatment is permitted for contributory defined benefit plans of state or local governments but not for the contributory defined benefit plans maintained by some private-sector firms. Allowing this pre-tax treatment will encourage employers and employees alike to remain committed to these contributory defined benefit plans rather than abandoning them for exclusively defined contribution arrangements (where employee contributions are typically pre-tax).
- Fourth, the Council believes that a legislative solution is necessary to address the growing administrative burdens attributable to "lost participants", *i.e.,* participants with relatively small benefits who cannot be located by plans. The cost for plans of maintaining records of these benefits and searching for the participants is significant, and a solution needs to be found. The Council believes that one option to explore is a material expansion of PBGC's missing participant program to apply to plans that have not terminated.
- Fifth, the Council recommends further simplification of the many complex rules governing defined benefit plans, many of which achieve little from a policy perspective but can make pension plan administration both more complicated and more costly.[7]

The Council hopes to work with Representatives Portman and Cardin, with you Chairman Houghton and Ranking Member Coyne, and with other leaders in Congress to see these additional defined benefit reforms included in the next generation of pension reform legislation.

Conclusion

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[7] What follows are several examples of defined benefit plan complexity in need of reform and simplification. Today when a defined benefit plan obtains from a participant a waiver of the qualified pre-retirement survivor annuity (QPSA) (with spousal consent) and the participant is younger than 35 years old, the plan must seek another waiver from the same participant (again with spousal consent) after he or she has attained age 35. Another example of needed reform is legislation to further facilitate the use of new technology in plan administration. This use reduces costs and improves accuracy, thereby clearly improving administrative efficiency. A final example is legislation that reduces unnecessary burdens on the many defined benefit plans that use base pay (or rate of pay) in their benefit formula. Current law requires such plans to perform complex testing not otherwise necessary. The Council would be pleased to share with interested Members of the Subcommittee our other recommended regulatory simplifications in the defined benefit area.

Mr. Chairman, I want to thank you once again for calling this hearing on what the Council believes to be one of the most important components of our nation's retirement system and for examining some of the most important retirement policy questions we as a nation face today. The Council feels strongly that we must ensure that both traditional and hybrid defined benefit plans remain viable choices for employers so that companies can select the pension plan design most suited to the needs and wishes of their workforce. Defined benefit plans offer unique advantages for employees, but without prompt action by Congress we fear these plans will increasingly disappear from the American pension landscape.

Thank you very much for the opportunity to appear today and I would be pleased to answer whatever questions you and the members of the Subcommittee may have.

Chairman HOUGHTON. Thank you very much. Mr. O'Flinn?

STATEMENT OF CHRISTOPHER W. O'FLINN, VICE PRESIDENT, CORPORATE HUMAN RESOURCES, AT&T CORPORATION, BASKING RIDGE, NEW JERSEY, AND CHAIRMAN, ERISA INDUSTRY COMMITTEE

Mr. O'FLINN. Mr. Chairman and Members of the Subcommittee, I appreciate the invitation to come here and present ERIC's views on what can be done to restore vitality to the defined benefit plan system.

We think it is imperative for Congress to make a fundamental change in the way it thinks about defined benefit plans and the laws that govern them. We would hope you would think of these plans as essential tools for providing retirement income to our citizens and not regard them as a source of revenue to achieve Congressional budgetary targets.

With this in mind, we hope that Congress would apply a tripartite evaluation to proposed legislation: first, from the employee's point of view, then the employer, plan sponsor, point of view, and lastly, the national interest. In other words, simply ask if the bill is going to provide additional security to employees, if it is going to encourage employers to sponsor defined benefit plans, and last, if it is going to strengthen the defined benefit plan system.

This is a simple criteria, but as some of the previous speakers have indicated, it was not followed in the 1980s and the early 1990s when Congress passed nine major pieces of legislation essentially designed to meet Congressional budgetary targets.

Through these laws and the regulations that followed, defined benefit plans were subjected to a bewildering array of complex, rigid, inconsistent, and unnecessarily burdensome legal requirements. The result, I think, is a part of the answer to a question Congressman Coyne asked earlier. The result is a complexity the level of which accounted for a part of the decline that previous speakers have testified to in the number of defined benefit plans.

Only recently, through the legislation sponsored by Representatives Portman and Cardin and other Members of this Committee, has Congress begun to move in a different direction and the Committee deserves the congratulations of those interested in retirement security for passing this legislation.

In other words, our answer to what is killing defined benefit plans is that in part the complexity of the regulatory environment is killing defined benefit plans. We would also point to another trend in the workplace. There is a trend that is characterized as additional mobility in the workforce.

Over the past 20 years, looking at folks today compared to say, 1983, there is a marked decline in the years spent with the current employer. This is tremendously significant to defined benefit plans participants. A traditional defined benefit plan rewards long service employees and they typically have about 15 years of service at age 55.

If you will look at some of the charts in the back of my testimony, you will see that, for example, for a male age 55, current employer tenure in 1983 was 15 years on average, which meant that individual met the requirements for significant benefits in a traditional defined benefit plan.

In other words, the typical person was on time to receive significant benefits. Today that figure is down to 10 years. In other words, the median employee is not on time to receive significant benefits under a traditional defined benefit plan. That means the plan is less significant to employees today, the traditional defined benefit plan, than it was in 1983.

If it is less significant to the employees, it is of less interest to the employer to sponsor it. We don't want to spend money sponsoring a plan that employees don't appreciate. Today, there is no question that employees appreciate traditional defined benefit plans much less than they did when they were on time to qualify for those significant benefits.

In terms of what can be done, we think, the cash balance plan, which as previous speakers have indicated, does not require long service and accrues benefits gradually over a period of time, is the answer for revitalizing the defined benefit area, keeping the risk of investments with the employer and providing a PBGC guarantee.

We also hope the Congress would address these critical questions that previous speakers have spoken about regarding the replacement for the 30-year Treasury bond rate and also address the funding issues applicable to defined benefit plans to permit us to reduce the volatility that characterizes current defined benefit plan funding. Thank you for this opportunity to address you.

[The prepared statement of Mr. O'Flinn follows:]

Statement of Christopher W. O'Flinn, Vice President, Corporate Human Resources, AT&T Corporation, Basking Ridge, New Jersey, and Chairman, ERISA Industry Committee

Chairman Houghton, Ranking Member Coyne, and members of the Subcommittee, good morning. I am Christopher O'Flinn. I am Vice President, Corporate Human Resources, at AT&T Corporation. I also serve as Chairman of The ERISA Industry Committee, commonly known as "ERIC." I appear before the Subcommittee today on ERIC's behalf.

ERIC is a nonprofit association committed to the advancement of the employee retirement, incentive, health, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, incentive, health care coverage, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

At the outset, ERIC wishes to express its deep appreciation for Chairman Houghton's introduction and sponsorship of H.R. 2695, which clarifies the employment tax treatment of statutory stock options to reflect Congress's intent and the IRS's longstanding administrative practice. We are gratified that the provisions of H.R. 2695 were also included in H.R. 3762, which was passed by the House earlier this year. ERIC strongly supports this clarification of existing law and is committed to working with Chairman Houghton to secure its prompt enactment.

ERIC is also gratified that Congressman Portman has introduced H.R. 4931, which would make permanent the ground-breaking employee benefit provisions that were included in the Economic Growth and Tax Relief Reconciliation Act of 2001. ERIC was a strong supporter of those provisions, and we look forward to working closely with Congressman Portman and the members of this Subcommittee to obtain enactment of H.R. 4931.

ERIC also commends Chairman Houghton and the members of the Subcommittee for holding this hearing on retirement security and defined benefit plans. The hearing will help to focus Congressional and public attention both on the importance of the voluntary defined benefit system in providing retirement security and on the improvements that need to be made in the system.

I am pleased to present ERIC's views both on the role and importance of voluntary defined benefit plans and on the improvements that need to be made in the defined benefit system.

A Fundamental Change in Thinking. We think that it is imperative for Congress to make a fundamental change in its way of thinking about defined benefit pension plans and the laws that govern them in order to encourage rather than discourage the formation and maintenance of such plans. Instead of thinking of defined benefit plans and the governing laws as a source of revenue to be used to achieve Congressional budgetary targets, Congress should think of them as essential tools for providing critically needed retirement benefits to millions of workers and their families. With this objective in mind, Congress should evaluate current or proposed legislation governing defined benefit plans in light of three basic questions:

1. **Employers' interests**: Does the legislation facilitate the ability and willingness of employers to establish and continue voluntary defined benefit plans that meet employers' business needs?
2. **Employees' interests**: Does the legislation enhance the abilityof employees to obtain retirement security?
3. **National interest**: Does the legislation strengthen the voluntary retirement system by encouraging employers to establish and maintain voluntary defined benefit plans?

Unless there are affirmative answers to all of these questions, the legislation is likely to undermine, rather than advance, the objective of providing retirement benefits to employees and their families in the context of a voluntary employer-sponsored system.

The pension reform provisions that were included in last year's Economic Growth and Tax Relief Reconciliation Act were a good step in this direction, and we are very appreciative of the efforts of the Chairman, Congressman Portman, and the other members of the Subcommittee in seeing to it that these provisions were enacted. But more—much more—needs to be done.

Because ERIC's members believe in the mission and ability of defined benefit plans to provide retirement security, ERIC's members have retained their defined benefit plans. It has not been easy for them to do so, however. The hostile regulatory environment for defined benefit plans requires even ERIC members to reassess their commitment to these plans.

For example, the Labor Department's Office of Inspector General (the "OIG") recently issued a critical report regarding lump-sum distributions from cash balance pension plans.[1] The OIG Report is based on a controversial legal theory that is contrary to both the law and sound retirement security policy.[2] Both the OIG Report itself and the OIG's release of related confidential information reflect such a lack of understanding and such a level of hostility toward cash balance plans that the Report could inflict irreparable damage on the nation's defined benefit system. Attached to this statement are copies of two ERIC submissions setting forth in detail ERIC's objections to the Report and the OIG's unwarranted release of confidential information.

The Need for Flexibility, Creativity, and Diversity. Congress needs to foster an environment that favors the creation and continuation of retirement plans and that permits employers to adopt a variety of approaches to providing retirement security. Congress must reform the rules governing defined benefit plans to reverse the dramatic decline in defined benefit plan coverage that has occurred over the past two decades. Congress also must make the law more hospitable to defined con-

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[1] U.S. Dep't of Labor, Office of Inspector General, *PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions* (Report No. 09–02–001–12–121) (March 29, 2002).

[2] The General Accounting Office found that there was "uncertainty" whether plan sponsors must adhere to this controversial legal theory. *See* General Accounting Office, *Private Pensions: Implications of Conversions to Cash Balance Plans* 21 (GAO/HEHS–00–185) (Sept. 2000).

tribution plans and to new types of plans, such as "hybrid" plans that seek to combine the best features of defined benefit and defined contribution plans in a single plan.

The same type of retirement plan is not suitable for all employers or for all workforces. Congress should seek to create a regulatory environment that—

- allows employers to create plans that work best for them and their employees,
- does not unnecessarily restrict employer flexibility with rigid, cumbersome rules, and
- allows employers to create new types of plans that do not necessarily fall within the rigid "defined benefit" and "defined contribution" categories.

The Decline in Defined Benefit Plan Coverage. Defined benefit plans provide valuable retirement benefits that typically are (1) not subject to investment risk, (2) guaranteed by the Pension Benefit Guaranty Corporation, (3) payable as an annuity, (4) are provided automatically to employees without any decision to participate on their part, and (5) are not contingent on employee contributions. However, although defined benefit plans provide valuable retirement security benefits to the millions of employees who participate in them, the coverage of these plans is declining, and the pace of decline accelerating. Statistics from a variety of sources point unequivocally to these conclusions:

- Since the enactment of ERISA in 1974, the percentage of private sector U.S. workers covered by defined benefit pension plan has dropped from 39% in 1975 to 23% in 1995.[3]
- The percentage of workers participating in defined benefit plans shrank by 0.8% per year from 1980 to 1985, by 2% from 1985 to 1990, and by 2.3 % from 1990 to 1995.[4]
- The number of active participants in defined benefit plans has fallen since 1984 by an average of about 2% per year.[5] Between 1979 and 1998, the number of defined benefit plan participants fell by over 22%, from 29.4 million to 22.9 million. During the same period, the number of defined contribution plan participants nearly tripled, from 17.4 million to 50.3 million.[6]
- Between 1988 and 1999, the number of active participants in PBGC-insured defined benefit plans fell by 18%, from 27.3 million to 22.4 million—notwithstanding the expansion of the total workforce during this period.[7]
- Virtually all of the growth in pension plan participation since the mid-1970s is attributable to the growth of § 401(k) defined contribution plans. Defined contribution plans covered 42% of the full-time employees in the private sector in 1999.[8]

Why has this happened? From the early 1980s until 1994, Congress piled law on top of law in an effort to meet Congressional budgetary targets by squeezing as much "tax revenue" out of defined benefit plans as it could. Through these laws, Congress created a regulatory climate that micro-managed these plans. The result was to subject defined benefit plans to a bewildering array of complex, rigid, inconsistent, and unnecessarily burdensome legal requirements.

The resulting legal regime has been excessive, oppressive, and convoluted. Its primary effect has been a decline in retirement security. It has discouraged many employers from adopting new plans and encouraged many others to terminate their existing plans. For example:

- New short-sighted funding rules have subjected employers to unrealistic funding assumptions and have limited employers' ability to fund their defined benefit plans until late in their employees' careers.
- Rigid restrictions on the use of pension assets have converted a defined benefit plan into a "black hole" from which contributions cannot emerge—even

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[3] Watson Wyatt Worldwide, *The Unfolding of a Predictable Surprise* at iii (2000).

[4] Id. at 2.

[5] U.S. Dep't of Labor, Pension & Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* No. 11 (Winter 2001—2002); Joint Committee on Taxation, *Background Information Relating to the Investment of Retirement Plan Assets in Employer Stock* 16 (JCX–1–02) (Feb. 11, 2002). Although the *Private Pension Plan Bulletin* shows a slight increase in the number of active participants in defined benefit plan participants between 1997 and 1998, the increase consists of fewer than 250,000 individuals, and was accompanied by a 5% *decline* in the number of defined benefit plans between 1997 and 1998. *See Private Pension Plan Bulletin* at 2, Tables E1 & E8.

[6] *Private Pension Plan Bulletin, supra,* Table E8.

[7] Pension Benefit Guaranty Corporation, 2001 Annual Report 14.

[8] U.S. General Accounting Office, *Private Pensions: Improving Worker Coverage and Benefits* 7–8 (GAO–02–225) (April 2002); JCX–1-02, *supra,* at 13, 16–17.

if the plan's assets vastly exceed the amount required to fund the plan's benefits.

- Complex, and frequently amended, legal requirements, including compensation and benefit limits and distribution rules have required plans to invest a substantial portion of their resources in legal compliance and plan administration, rather than in providing benefits to participants and beneficiaries.

This regime has weakened retirement security by delaying funding, by subjecting employers to highly volatile funding requirements that are difficult, if not impossible, for employers to predict, by subjecting plans to excessive administrative costs, and, in the aggregate, by making it less attractive for employers to maintain and contribute to defined benefit plans.

The decline in defined benefit plan coverage has substantially weakened the retirement security of our nation's workforce.

The Development of Cash Balance and Other "Hybrid" Plans. The one exception to the dramatic decline in defined benefit plan coverage has been the emergence of cash balance and other "hybrid" defined benefit plans. Although these plans are defined benefit plans, they combine many of the most attractive features of both defined benefit and defined contribution plans.

Traditional defined benefit pension plans typically provide benefits pursuant to a formula that expresses an employee's benefit as a deferred annuity, commencing at the plan's normal retirement age (generally, age 65).

A cash balance pension plan is a defined benefit plan that defines an employee's benefit as the balance in his or her cash balance account. The account receives periodic credits, usually a percentage of the employee's pay, while the employee works. In addition, the account is credited with interest until the account balance is distributed.[9]

Traditional defined benefit plans provide extremely valuable benefits to broad groups of employees in many segments of our economy, especially those where long-term employment is prevalent and where many employees remain with their employers for most or all of their careers.

In other segments of the economy, however, most of the benefits provided by a traditional defined benefit plan are allocated to a relatively small group of long-service employees, and the vast majority of plan participants receive little or no benefits. Traditional defined benefit plans often penalize older employees who want to work beyond early retirement age. Traditional plans also can restrict the mobility of younger employees who risk losing a substantial portion of their retirement benefits if they leave the employer before reaching early retirement age.

Since 1983, there has been a marked drop-off in the median job tenure for the average employee, reflecting the fact that employees now spend shorter periods of time with a single employer. This phenomenon is documented by the three tables at the end of this statement.

Because cash balance and other "hybrid" plans allocate benefits more evenly over an employee's career, these plans correct many of the shortcomings of traditional defined benefit plans and are particularly well-suited to an employee who does not spend his or her entire career with a single employer.

Advantages to Employees:

- **Understandable Benefits:** Unlike traditional defined benefit plans, cash balance plans provide an easily understood account balance for each participant. Employees—who are accustomed to dealing with bank account balances, § 401(k) account balances, and IRA balances—are comfortable with a retirement plan that provides a benefit in the form of an account balance.
- **Automatic Savings:** Unlike § 401(k) plans, additions are made automatically to the accounts of all participants in a cash balance plan. An employee does not have to choose to participate or decide how much to contribute.
- **Employees Do Not Bear Investment Risk:** Unlike § 401(k) plans and other defined contribution plans, cash balance plans do not require employees to bear the risk of adverse investment experience. As under a traditional defined benefit plan, the employer bears the risk that the plan's investments will perform poorly. Sudden or even prolonged downturns in the plan's investment

[9] Another form of "hybrid" plan—a pension equity plan—works differently. Like a cash balance plan, a pension equity plan defines the participant's benefit in terms of a lump sum—but without relying on an account or interest credits. For example, a pension equity plan might define a participant's lump-sum benefit as a specified percentage of final average pay multiplied by the participant's years of service with the employer. For example, if the specified percentage were 8%, and the participant completed 10 years of service, the participant's lump-sum benefit would be 80% of his or her final average pay.

performance do not affect participants' benefits under the plan. Because they are defined benefit plans, cash balance plans are insured by the Pension Benefit Guaranty Corporation (the "PBGC") and are subject to the stringent limits on investments in employer stock that apply to defined benefit plans.

- **Greater Benefits for More Employees:** Under a traditional pension plan, an employee typically earns most of his or her benefits in the last few years before retirement. By contrast, a cash balance plan allocates benefits more evenly over an employee's career, regardless of whether the employee remains with the employer until retirement. Because most employees do not remain with the same employer until retirement, the vast majority of workers earn greater benefits under cash balance plans than under traditional pension plans.
- **Women Benefit:** Cash balance plans offer significant advantages to women and others who tend to move in and out of the workforce. Mobile workers—not just women—are more likely to accrue a significant and secure retirement benefit under a cash balance plan than under many other plan designs.
- **Release from "Pension Jail":** Because the benefits under cash balance plans tend to accrue more evenly over an employee's career than do the benefits under a traditional defined benefit plan, and do not suddenly "spike" when an employee becomes eligible for early retirement, cash balance plans release many employees from what is often referred to as "pension jail"—the need to remain employed with the same employer until early retirement age in order to qualify for a major portion of the benefit that their retirement plan provides.
- **Older Workers Benefit:** The value of the benefit earned by an older worker increases at the same rate both before and after normal retirement age. By contrast, under many traditional pension plans, the value of the benefits accrued each year actually often declines when an employee works beyond a certain age (normal retirement age or early retirement age in the case of a plan providing subsidized early retirement benefits).
- **Portable Benefits:** Cash balance benefits are portable. An employee who leaves before retirement can roll over his or her cash balance account to an IRA or a new employer's plan.
- **Annuities Available:** Since cash balance plans must offer annuities, a participant who wants to receive retirement benefits as a stream of income for life can receive a life annuity without incurring the cost and inconvenience of shopping for an annuity in the individual annuity market. Annuity benefits are also available to the surviving spouses of deceased plan participants.

Advantages to Employers. Cash balance plans offer the following important advantages to employers:

- **Appropriate Employment Incentives:** Because cash balance benefits are easy to communicate, because employees understand and value cash balance benefits, and because cash balance benefits accrue much earlier in a participant's career than do the benefits under most traditional defined benefit plans, cash balance plans strengthen employer efforts to recruit and retain productive employees.
- **Appropriate Retirement Incentives:** Because cash balance plans do not provide sudden "spikes" in benefits when an employee reaches early retirement age, they do not encourage productive workers to retire (and perhaps go to work for a competitor) as soon as they reach retirement age.
- **Benefit Funding:** Under a cash balance plan, benefits accrue much earlier in a participant's career, and the value of current accrued benefits does not depend on an employee's future earnings. This enables the employer to fund a much larger portion of the plan's projected benefit obligations—the value of the benefits that employers are required to use as a funding target for accounting purposes—than under a traditional defined benefit plan.[10] This increases employees' retirement security.
- **Benefit Communication and Coordination:** Because the benefits under a cash balance plan are expressed as a lump sum, they can be more easily communicated and coordinated with other employer-provided benefits (*e.g.,* § 401(k) plan benefits) that are also expressed as lump sums.

Advantages to the Nation

[10] *See* Watson Wyatt, *supra,* at 14–20, 48–53.

- **Increased Coverage:** Because cash balance and other "hybrid" plans are the only defined benefit plans currently attracting the interest of employers and employees, they currently offer the greatest hope for maintaining and actually increasing defined benefit plan coverage in the United States.
- **Increased Retirement Security:** Because cash balance and other "hybrid" plans are defined benefit plans, they provide a reliable source of retirement security.
- **Increased Labor Mobility:** Because cash balance plans do not encourage employees to remain employed until they qualify for early retirement, they increase labor mobility.
- **Greater Independence for Women:** Because cash balance plans offer significant advantages to women and others who tend to move in and out of the workforce, cash balance plans provide greater financial independence for women and other mobile workers.
- **Less Pressure on Government Programs:** The success of defined benefit plans, and cash balance plans in particular, will relieve pressure on federal and state governments to provide retirement and other financial assistance to elderly citizens.

Congress Should Act. Congress must act promptly if it wishes to reverse the decline of the defined benefit plan. Although there are many steps that can and should be taken, we suggest the following as a start:

Encourage Hybrid and Other Innovative Plan Designs: Congress should enact legislation directing the Treasury Department and other federal agencies to create an environment that encourages the development and maintenance of hybrid and other innovative plan designs.

Reform the Funding Standards: Congress should reform the current funding rules to make the funding of defined benefit plans more sound, less volatile, more flexible, and more consistent with sound funding principles. The funding standards should be designed to meet retirement security needs, not short-term Congressional budget targets.

Replace the 30-Year Treasury Bond Rate: Congress should establish a permanent replacement for the 30-year Treasury bond standard used to set the interest rate for purposes of pension funding, the variable rate PBGC premium, and lump-sum benefits under defined benefit plans. We suggest that the yield on the 30-year Treasury bond be replaced by the composite yield on high quality, long-duration corporate bonds, based on the average yield reported by a number of independent indices. The composite yield would be representative of rates of return that underlie the price of annuities sold by insurers active in the group annuity marketplace.

ERIC expects to present specific proposals on improvements in the funding standards and on a permanent replacement for the 30-year Treasury bond standard to Congress for consideration in the near future.

Permit Excess Pension Assets to be Used to Fund Defined Contribution Plans: Congress should enact legislation that permits the excess assets of defined benefit plans to be used to enhance the retirement security of plan participants by transferring them to a defined contribution plan for the benefit of participants in the defined benefit plan. The legislation should be modeled on the current provisions of § 420 of the Internal Revenue Code, which permits excess pension assets to be transferred to an account to provide retiree health benefits. Section 420 has worked well for many year, and has been extended by Congress on two separate occasions. The favorable experience under § 420 argues strongly in favor of this proposal.

As I explained at the beginning of my statement, Congress should evaluate these and other proposals in light of the following questions:

1. **Employers' interests:** Does the legislation facilitate the ability and willingness of employers to establish and continue voluntary defined benefit plans that meet employers' business needs?
2. **Employees' interests:** Does the legislation enhance the ability of employees to obtain retirement security?
3. **National interest:** Does the legislation strengthen the voluntary retirement system by encouraging employers to establish and maintain voluntary defined benefit plans?

With respect to the proposals we have made, the answer to each of these questions is an unequivocal "Yes," and we urge the Subcommittee to act on our proposals promptly.

In its deliberations, the Subcommittee should continue to be mindful of the critical role that a diverse array of voluntary employer-sponsored plans play in providing retirement security to millions of American workers and their families. Al-

though defined benefit plans are the focus of this hearing, defined contribution plans also play a critical role in providing retirement security. Improvements in the law governing defined benefit plans should not be made at the expense of defined contribution plans.

Finally, with the reemergence of federal budget deficits, we urge the Subcommittee not to repeat the disastrous experience of the period from 1982 through 1994. Retirement plans should now be viewed as a critical vehicle for providing retirement security to workers and their families, not as a source of revenue to be used to achieve Congressional budgetary targets.

We very much appreciate the opportunity to present our views today to the Subcommittee. We look forward to working with Chairman Houghton, Ranking Member Coyne, and the other members of the Subcommittee and their staffs on the important issues that the Subcommittee has raised.

Attachment 1:
May 21, 2002

The Honorable Elaine L. Chao
Secretary of Labor
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington. DC 20210

Dear Secretary Chao:

On March 29, 2002 the Department of Labor Office of Inspector General (OIG) released a report regarding lump-sum distributions from cash balance pension plans (Report).[11] Based on information collected from a "judgmental sample" of 60 companies, the Report propounds that 13 of the sampled companies failed to properly calculate the lump-sum benefit.[12] For the reasons described below, we are writing to strongly object to and request an investigation of the violation of a promise of confidentiality by the OIG intended to induce cooperation by the companies in the sample.

On May 20, 2002 Representative Bernie Sanders (I–VT) released information to the press and media and published on his Web site the names of the 13 companies alleged by the OIG to have underpaid participants.[13] Representative Sanders specifically cites the Department of Labor Office of Inspector General as the source of his information.

We strongly believe that the release of the information by the DoL OIG was improper and requires an investigation and appropriate action against those responsible for leaking information that was confidential and therefore protected.

In its effort to collect information from the 60 companies in its "judgmental sample," including the 13 companies cited by Representative Sanders, the OIG specifically stated that they were conducting "an audit of the Department's oversight of defined benefit plans that have converted to a cash balance formula."

As an inducement for cooperation in obtaining information about benefit calculations and other data necessary for their audit of the Department's oversight responsibilities, the OIG specifically promised the companies that:

". . . the information you will provide is considered confidential. The results of our review of your information will be combined with reviews of other plans and will be used to develop a report to Department of Labor management officials. The report will not identify any plans or plan sponsors by name or other identifying means." (See attachment 2.)

The release of the information to Representative Sanders is a clear and egregious violation of the confidentiality promise made by the OIG to each company from which it requested information. While the report itself did not identify the companies, the release of the information to Representative Sanders nevertheless constitutes a breach of the confidentiality promised by the OIG. Moreover, Representative Sanders is well known to be strongly opposed to cash balance plans. Thus, the release of the information to Representative Sanders, particularly in light of the specific promise of confidentiality, conflicts with an objective that is consistent with

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[11] U.S. Department of Labor, Office of Inspector General, "PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions" (Report No. 09–02–001–12–121).

[12] For reasons explained in our May 16, 2001 letter to you and to Secretary of the Treasury Paul O'Neill, we contend that the OIG Report is based on an illegitimate and ill-conceived legal theory, an uncritical and unsupported acceptance of that theory, and a misapplication of the Department of Labor's authority over cash balance plans.

[13] http://bernie.house.gov/documents/releases/20020520161735.asp

the requirements of objectivity and independence of the Department's Inspector General.

The OIG's apparent release of confidential information will have a significant chilling effect on the willingness of employers and plan sponsors to cooperate with the Department of Labor in the future. It casts a shadow over the objectivity of the Office of Inspector General and raises significant questions with regard to controls within that office.

For the reasons indicated, we respectfully urge that the Department initiate an investigation of the OIG and, if the OIG is in fact the source of the breach of confidentiality, take corrective steps to ensure the integrity of the Department and the Office of Inspector General.

Very truly yours,

Mark J. Ugoretz
President

cc: Hon. Ann Combs, Assistant Secretary for Pensions and Welfare Benefits Administration
Elliott P. Lewis (Acting Deputy Inspector General for Audit, USDoL)

Attachment 2:
May 16, 2002

BY HAND DELIVERY

The Honorable Elaine L. Chao
Secretary of Labor
U.S. Department of Labor
200 Constitution Avenue, NW.,
Washington, DC 20210

The Honorable Paul H. O'Neill
Secretary of the Treasury
U.S. Treasury Department
1500 Pennsylvania Avenue, NW.,
Washington, DC 20220

Re: Lump-Sum Distributions from Cash Balance Pension Plans

Dear Secretary Chao and Secretary O'Neill:

We are writing to express our strong concerns about the report recently issued by the Office of Inspector General of the Department of Labor regarding lump-sum distributions from cash balance pension plans (the "OIG Report").[14]

The OIG Report threatens to damage our Nation's private pension system by creating the impression that many pension plans are underpaying plan participants. We urge you to act promptly to dispel this erroneous impression.

The OIG Report is based on an invalid legal theory that is contrary to both the law and sound retirement security policy. Moreover, the Treasury Department, not the Department of Labor, is responsible for interpreting the statutory provisions on which this legal theory is based.

At a time when some employers are shifting away from defined benefit pension plans, and when many employees are seeking the retirement security that defined benefit plans provide, it is imperative for the Administration to support the development of defined benefit plans that meet employee needs. Because they are defined benefit plans, cash balance plans provide benefits that employees can rely on, without the risk of adverse investment experience. Because of their design, cash balance plans provide portable retirement benefits that are allocated equitably over an employee's career.

Cash balance plans address the needs of millions of employees, including women, who do not spend their entire career with a single employer. Cash balance plans provide benefits that grow steadily over time in a fair and equitable manner. The Administration should create an environment that fosters the creation and continuation of such plans, not an environment that is hostile to them.

The OIG Report is based on a "whipsaw" theory that undermines many cash balance plans. The OIG Report uncritically propounds the whipsaw theory as established law even though the whipsaw theory violates established law and fundamentally alters the benefit promised by a cash balance plan. The whipsaw theory requires cash balance plans to violate federal law and undermines important federal

[14] U.S. Dep't of Labor, Office of Inspector General, "PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions" (Report No. 09–02–001–12–121) (March 29, 2002).

policies. By altering the plan's benefit promise, the whipsaw theory improperly restricts the freedom that employers have under existing law to determine the benefits that their plans provide.[15]

Cash Balance Plans

Traditional defined benefit pension plans typically provide benefits pursuant to a formula that expresses an employee's benefit as a deferred annuity, commencing at the plan's normal retirement age (generally, age 65). A cash balance pension plan is a defined benefit plan that defines an employee's benefit as the balance in his or her cash balance account. The account receives periodic credits, usually a percentage of the employee's pay, while the employee works. In addition, the account is credited with interest until the account balance is distributed. Because the interest credits typically are based on a variable index, it is impossible to know in advance the rate at which a participant's cash balance account will grow.

Cash balance plans offer the following important advantages:

- **Understandable Benefits:** Unlike traditional defined benefit plans, cash balance plans provide an easily understood account balance for each participant. Employees—who are accustomed to dealing with bank account balances, § 401(k) account balances, and IRA balances—are comfortable with a retirement plan that provides a benefit in the form of an account balance.
- **Automatic Savings:** Unlike § 401(k) plans, additions are made automatically to the accounts of all participants in a cash balance plan. An employee does not have to choose to participate or decide how much to contribute.
- **Employees Do Not Bear Investment Risk:** Unlike § 401(k) plans and other defined contribution plans, cash balance plans do not require employees to bear the risk of adverse investment experience. As under a traditional defined benefit plan, the employer bears the risk that the plan's investments will perform poorly. Sudden or even prolonged downturns in the plan's investment performance do not affect participants' benefits under the plan. Because they are defined benefit plans, cash balance plans are insured by the Pension Benefit Guaranty Corporation (the "PBGC") and are subject to the stringent limits on investments in employer stock that apply to defined benefit plans.
- **Greater Benefits for More Employees:** Under a traditional pension plan, an employee typically earns most of his or her benefit in the last few years before retirement. By contrast, a cash balance plan allocates benefits more evenly over an employee's career, regardless of whether the employee remains with the employer until retirement. Because most employees do not remain with the same employer until retirement, the vast majority of workers earn greater benefits under cash balance plans than under traditional pension plans.
- **Women Benefit:** Cash balance plans offer significant advantages to women and others who tend to move in and out of the workforce. Mobile workers—not just women—are more likely to accrue a significant and secure retirement benefit under a cash balance plan than under many other plan designs.
- **Older Workers Benefit:** The value of the benefit earned by an older worker increases at the same rate both before and after normal retirement age. By contrast, under many traditional pension plans, the value of the benefits accrued each year actually often declines when an employee works beyond a certain age (normal retirement age or early retirement age in the case of a plan providing subsidized early retirement benefits).
- **Portable Benefits:** Cash balance benefits are portable. An employee who leaves before retirement can roll over his or her cash balance account to an IRA or a new employer's plan.
- **Annuities Available:** Since cash balance plans must offer annuities, a participant who wants to receive retirement benefits as a stream of income for life can receive a life annuity without incurring the cost and inconvenience of shopping for an annuity in the individual annuity market. Annuity benefits are also available to the surviving spouses of deceased plan participants.

As the preceding discussion demonstrates, an essential feature of a cash balance plan is its ability to express an employee's benefit as a current lump-sum value and to pay out that benefit in a lump sum equal to the current balance in the employee's

[15] We focus on cash balance plans because the OIG Report focused on such plans. However, the concerns that we voice in this letter would also apply to any attempt to apply the whipsaw theory to other types of "hybrid" plans (defined benefit plans that express their benefits as something other than an annuity beginning at normal retirement age).

cash balance account. Without this feature, a cash balance plan cannot (1) provide readily understood benefits to employees, (2) distribute benefits equitably among employees, and (3) provide lump-sum benefits that are not subject to erratic interest-rate swings. The whipsaw theory would prevent many cash balance plans from achieving these objectives. As we explain in detail below, the whipsaw theory—

- Has no statutory support;
- Conflicts with the statute and the regulations;
- Conflicts with other statutory and regulatory provisions;
- Discourages the deferral of benefits until retirement;
- Discourages participants from electing to receive annuities;
- Weakens spousal protections;
- Hurts employees by limiting plans' interest crediting rates;
- Favors younger employees over older employees;
- Provides erratic benefits;
- Provides windfall benefits;
- Interferes with employer-employee relationships;
- Weakens pension funding;
- Risks weakening the PBGC; and
- Discourages employers from adopting defined benefit plans.

The Whipsaw Theory

Under the whipsaw theory, an employee's cash balance account must be projected forward to normal retirement age at the interest rate set forth in the plan (which is typically based on a variable index) and then discounted back to an actuarial present value using the 30-year Treasury interest rate—the rate specified by Code §§ 411(a)(11) and 417(e) and ERISA §§ 203(e) and 205(g).[16] If the resulting amount exceeds the balance in the employee's current cash balance account, the lump-sum distribution payable to the employee must be increased to the amount determined under the whipsaw calculation, producing a windfall benefit to the employee-a benefit that the plan was not designed to provide and a benefit that the employee had no reason to anticipate.

The windfall benefit mandated by the whipsaw theory is payable whenever the plan's current interest rate exceeds the statutory interest rate (the 30-year Treasury rate). Projecting out an employee's cash balance account at the plan's interest rate and then discounting it back at a lower statutory interest rate will always yield an amount larger than the balance in the employee's cash balance account.

The amount of the windfall benefit mandated by the whipsaw theory will increase the younger an employee is at the time he or she receives a lump-sum distribution. The age-based difference in amount is attributable to the fact that the interest rate differential that produces the windfall benefit will apply over a longer period for a younger employee and therefore will produce a larger windfall benefit for a younger employee than for a similarly-situated older employee. In most cases, the windfall benefit will disappear entirely for any employee at or over normal retirement age (typically, age 65) at the time of the distribution.

The windfall benefit mandated by the whipsaw theory also disappears for any employee who receives his or her benefit under the cash balance plan as a non-decreasing annuity, rather than as a lump sum. This is because the statutory interest rate does not apply to such annuities, while it does apply to lump sums.

The OIG Report

The OIG Report is seriously flawed, both procedurally and substantively.

First, the validity of the whipsaw theory is within the jurisdiction of the Treasury Department, not the Labor Department. This is because the whipsaw theory purports to be based on the vesting and benefit accrual provisions of the Code and ERISA. The Treasury Department, not the Labor Department, is responsible for interpreting and applying the vesting and benefit accrual provisions.[17]

Second, although the Treasury has indicated that it is developing regulations that will address the whipsaw issue,[18] the Treasury has not issued even proposed regulations. Under the circumstances, it is inappropriate for the Department of Labor's OIG to apply the theory.

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[16] References in this letter to "ERISA" are to the Employee Retirement Income Security Act of 1974, as amended, and references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[17] *See* ERISA § 3002(c); Presidential Reorganization Plan No. 4 of 1978, § 101, 5 U.S.C. App. (2000), 43 Fed. Reg. 47713 (Oct. 17, 1978); *see also* 29 C.F.R. § 2530.200a-2.

[18] IRS Notice 96–8, 1996–1 C.B. 359.

Third, the OIG appears to have misapplied the whipsaw theory in at least some cases. Our understanding is that the OIG concluded that at least one of the plans that it criticized failed to comply with IRS Notice 96–8 because the lump-sum distributions under the plan were not actuarially equivalent to the plan's qualified joint and survivor annuity. This conclusion is completely at odds with the view of the Internal Revenue Service that a lump-sum distribution need only be actuarially equivalent to the plan's *single life annuity.*[19]

Fourth, the whipsaw theory is highly controversial.[20] Although the Internal Revenue Service endorsed the whipsaw theory in Notice 96–8, the Service's failure to issue proposed regulations has thus far shielded the theory from the scrutiny of a formal rulemaking. An OIG Report is not a substitute for a rulemaking proceeding nor is it an appropriate vehicle for addressing or resolving an important and controversial policy issue.

Fifth, notwithstanding the controversial nature of the whipsaw theory, the OIG Report accepts it as a "given." The Report utterly fails to consider whether the whipsaw theory is consistent with applicable statutory and regulatory provisions and does not address the very powerful arguments that the whipsaw theory is simply wrong.[21]

As we explain below, the whipsaw theory—the Report's lynchpin—is inconsistent with applicable statutory and regulatory provisions and with important federal policies.

The Whipsaw Theory Is Invalid

The Whipsaw Theory Has No Statutory Support. The whipsaw theory appears nowhere in the Code, ERISA, or the regulations. Where the plan's interest credit rate is based on a variable index, projecting the current rate forward to normal retirement age (perhaps 30 or 40 years into the future) is inherently nonsensical. There is no reason to believe that current interest rates are predictive of future rates, and there is no reason to believe that Congress intended them to be used to predict the annuity benefit a participant would be entitled to receive many years in the future.

The Whipsaw Theory Conflicts with the Statute and the Regulations. The whipsaw theory conflicts with the statutory and regulatory provisions that govern how an accrued benefit expressed in the form of an annuity beginning at normal retirement age is to be derived in the case of a plan that does not define its benefits in that way.

Under both the Code and ERISA, if a plan (such as a cash balance plan) does not provide an accrued benefit in the form of an annuity beginning at normal retirement age, the statutory "accrued benefit"—which must be used to determine the minimum amount of a lump-sum distribution—is an annuity beginning at normal retirement age that is the actuarial equivalent (determined under Code § 411(c)(3) and ERISA § 204(c)(3)) of the accrued benefit under the plan.[22]

Actuarial equivalence under Code § 411(c)(3) is determined using the assumptions specified by Code § 417(e). This is made clear both by the statute and the regulations. Code § 411(c)(3) refers to Code § 411(c)(1) & (2). Under Code § 411(c)(2)(B), an account balance is converted to an annuity beginning at normal retirement age

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[19] *See* T.D. 8219, 53 Fed. Reg. 31837, 31840 (Aug. 22, 1988) ("There is no requirement that each form of benefit be the actuarial equivalent of all other benefit forms. Thus, a plan could have a [qualified joint and survivor annuity] benefit form that has a larger actuarial value than a benefit payable as a single life annuity and the amount of a single sum optional form could be determined based on the single life annuity.... Thus, a plan may satisfy [the] requirements [of Code §§ 411(a)(11) and 417(e)] even though it has a subsidized joint and survivor annuity and determines a single sum distribution based on an unsubsidized single life annuity.").

[20] *See, e.g.,* Sennott, *Finding the Balance in Cash Balance Pension Plans*, 2001 U. Ill. L. Rev. 1059 (2001); Lurie, *Caught in the Jaw of the Saw: A Bum Rap for Cash Balance Plans,* 89 Tax Notes 549 (Oct. 23, 2000).

[21] Courts of appeal in two of the 13 federal circuits have applied the whipsaw theory. *See Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000); *Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000). Those courts applied the whipsaw theory under the pre-1995 version of the statute, however; they did not apply it under current law. *See Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan*, No. 97–CV–980, 2002 WL 415393 (N.D. Ga. March 12, 2002). Moreover, the *Esden* and *Lyons* courts did not have the benefit of the arguments made in this letter, and their decisions are not binding in the remaining 11 circuits in any event. At least one court has expressed serious reservations regarding the reasonableness of projecting variable-rate interest credits forward to normal retirement age (as the whipsaw theory requires). *See Eaton v. Onan Corp.,* 117 F. Supp.2d 812, 833 (S.D. Ind. 2000).

[22] Code § 411(a)(7)(A)(i); ERISA § 3(23); Treas. Reg. § 1.411(a)-7(a)(1)(ii).

based on the assumptions specified by Code § 417(e). The corresponding ERISA provisions say the same thing.[23]

Similarly, the implementing regulation, Treas. Reg. § 1.411(a)-7(a)(1)(ii), provides that where a defined benefit plan does not provide an accrued benefit in the form of an annuity beginning at normal retirement age, "accrued benefit" means an annuity beginning at normal retirement age that is "the actuarial equivalent (determined under § 411(c)(3) and § 1.411(c)-5 of the accrued benefit determined under the plan."[24] The IRS guidance under Code § 411(c) provides that actuarial equivalence is to be determined using the interest rate assumptions of Code § 417(e), not the interest credit rate set forth in the plan.[25]

The Whipsaw Theory Conflicts with Other Statutory and Regulatory Provisions. A statute must be interpreted in a manner that harmonizes all of its provisions.[26] As we explain in the following paragraphs, the whipsaw theory produces results that conflict with the objectives of other statutory and regulatory provisions.

A Plan's Use of the Whipsaw Method Would Be Unlawful Because It Discourages the Deferral of Benefits Until Retirement Age. A plan that used the whipsaw method would violate Code § 411(a)(11) and ERISA § 203(e)—the very sections that are claimed to be the basis for the whipsaw theory.

Under the whipsaw theory, an employee who terminates employment before normal retirement age faces a dilemma. If the employee does not agree to receive an immediate lump-sum distribution, and instead leaves his or her benefit in the plan until normal retirement age, the employee will forgo the additional benefit mandated by the whipsaw theory. For younger employees especially, the amount at stake could be substantial.

However, the regulations under Code § 411(a)(11) forbid a plan from putting an employee in this predicament. They specifically prohibit a plan from imposing a substantial detriment on any employee who does not consent to an immediate distribution.[27] The Internal Revenue Service has found a substantial detriment to exist as a result of plan provisions with far less consequence than what is at stake here.[28] The whipsaw theory cannot be valid if it requires a plan to violate the very statute on which the whipsaw theory is based.

The Whipsaw Theory Discourages Participants From Electing to Receive Annuities. Because the whipsaw theory rewards employees who elect to receive their benefits as immediate lump sums, it conflicts with the provisions of the Code and ERISA that favor the distribution of benefits in the form of an annuity.[29] Because benefits paid in the form of a nondecreasing annuity are not subject to the present value requirements of the Code and ERISA, the whipsaw theory does not apply to them. Because annuitants do not receive whipsaw benefits, the whipsaw theory discourages employees from electing to receive their benefits as annuities.

The Whipsaw Theory Weakens Spousal Protections. Both the Code and ERISA go to great lengths to protect employees' spouses. A defined benefit plan is required to protect the spouse with a qualified preretirement spouse's annuity (a "QPSA") before the employee retires and with a qualified joint and survivor annuity (a "QJSA") after the employee retires—unless the employee elects otherwise with his or her spouse's consent.[30] By providing a powerful economic incentive to elect to receive lump-sum benefits, the whipsaw theory undermines this important federal policy.

The Whipsaw Theory Hurts Employees by Limiting Plans' Interest Crediting Rates. According to Notice 96–8, whipsaw can be avoided if the plan's interest crediting rate does not exceed the statutory interest rate under Code § 417(e) and ERISA § 203(e). This creates incentives that are contrary to the interests of employ-

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[23] *See* ERISA § 204(c)(2)(B), (c)(3).

[24] The reference to 1§1.411(c)-5 appears to be a typographical error; there has never been a § 1.411(c)-5. We suspect that the reference was intended to be to § 1.411(c)-1, the only regulation ever issued under Code § 411(c).

[25] *See* Treas. Reg. § 1.411(c)-1(e)(1); IRS Employee Plans Examination Guidelines [7.7.1] 10.3.1.A (03–11–1998); IRS Announcement 95–33, ¶362.1(1)(a), 1995–19 I.R.B. 14 (April 17, 1995).

[26] *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) ("A court must... interpret [a] statute as a symmetrical and coherent regulatory scheme and fit, if possible, all parts in an harmonious whole.") (internal quotations and citations omitted); *Richards v. United States,* 369 U.S. 1, 11 (1962) ("We believe it fundamental that a section of a statute should not be read in isolation from the context of the whole Act.").

[27] *See* Treas. Reg. § 1.411(a)-11(c)(2)(i).

[28] *See* Rev. Rul. 96–47, 1996–2 C.B. 35 (loss of the right to choose among a broad range of investment alternatives is a substantial detriment to declining to consent to an immediate distribution from the plan).

[29] Code §§ 411(a)(11), 417; ERISA §§ 203(e), 205.

[30] *See* Code § 417; ERISA § 205.

ees. Because the whipsaw theory imposes unintended liabilities only on plans with interest crediting rates exceeding the statutory interest rate, it discourages employers from offering a plan with an interest rate exceeding the statutory rate. This clearly conflicts with the objectives of the Code and ERISA, which are designed to *encourage* employers to provide benefits to their employees. Contrary to federal policy, whipsaw punishes employers for being generous to their employees.

The Whipsaw Theory Favors Younger Employees Over Older Employees. The additional benefit mandated by the whipsaw theory also produces large age-based disparities in benefits. Under the whipsaw theory, employees of different ages who have the same pay and service history with the employer (and therefore the same account balances) will receive dramatically different lump-sum benefits based solely on the difference in their ages. A younger employee will receive a larger lump sum than a middle-aged employee, and a middle-aged employee will receive a larger lump sum than an employee who is past normal retirement age (who will in most cases receive no benefit from whipsaw at all). The adverse impact on older employees can hardly be said to promote the policy against age discrimination reflected in Code § 411(b)(1)(H), ERISA § 204(b)(1)(H), and § 4(i)(1) of the Age Discrimination in Employment Act.

The Whipsaw Theory Provides Erratic Benefits. Because whipsaw occurs only when the plan's interest crediting rate exceeds the statutory interest rate, whipsaw causes benefits to vary erratically from one year to the next based on fluctuations in interest rates. The wide swings in the benefits provided by whipsaw are contrary to the interests of employees who will not be able to predict their benefits from one year to the next and whose lump-sum benefits in one year will significantly erode (or increase) in the next.

The Whipsaw Theory Provides Windfall Benefits. Cash balance plans are designed to provide a lump-sum benefit equal to the balance in an employee's cash balance account. Because the whipsaw theory requires a cash balance plan to provide additional benefits when the plan's interest crediting rate exceeds the statutory rate, whipsaw causes a cash balance plan to provide windfall benefits—benefits that the plan was not intended to provide and that employees had no reason to anticipate.

The Whipsaw Theory Interferes with Employer-Employee Relationships. Whipsaw interferes with employer-employee relationships by encouraging employees to quit rather than to work. Because whipsaw benefits vary erratically from year to year, whipsaw encourages employees to quit, and to take lump-sum distributions, in order to capture whipsaw benefits before they disappear.

The Whipsaw Theory Weakens Pension Funding. The erratic swings in benefits under the whipsaw theory will impair sound pension funding. Unanticipated benefit increases will create or increase unfunded pension liabilities, encourage employees to terminate employment and withdraw their benefits in a lump sum, and jeopardize the plan's funded status. Such unexpected increases in benefit liabilities and cash outflows will undermine the objective of the Code and ERISA to strengthen pension funding.[31]

The Whipsaw Theory Risks Weakening the PBGC. Whipsaw's adverse impact on pension funding will also impose additional and unpredictable liabilities on the PBGC, the federal agency that is required to insure terminated defined benefit pension plans. If employers are unable to fund the additional benefits that the whipsaw theory creates, those benefits will eventually be shifted to the PBGC.[32] Whipsaw could weaken the PBGC's financial condition and undermine the soundness of the termination insurance program.

The Whipsaw Theory Discourages Employers from Adopting Defined Benefit Plans. For the reasons identified in the preceding paragraphs, the OIG Report's use of the whipsaw theory may discourage employers from adopting cash balance and other hybrid plans—plan designs that, unlike many traditional plan designs, are currently attracting employers to the defined benefit plan system. But beyond that, there is the even more worrisome risk that the Report's use of the whipsaw theory will do lasting damage to the define benefit plan system as a whole. We are concerned that the Report reflects a level of government hostility toward defined benefit plans, and a lack of understanding of those plans, that will reinforce the inclination of many employers to shy away from defined benefit plans altogether.

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[31] *See* Code § 412; ERISA §§ 301–08.

[32] *Cf.* Pension Benefit Guaranty Corp., *Title IV Aspects of Cash Balance Plans With Variable Indices*, 65 Fed. Reg. 41610 (July 6, 2000).

Conclusion

At a time when millions of employees are looking increasingly for retirement security, it is crucial for the Administration to support the development of secure cash balance and other defined benefit plans.

As a defined benefit plan, a cash balance plan provides benefits that employees can rely on, without the risk of adverse investment experience. Cash balance plans provide secure and equitable benefits that meet the needs of millions of employees, including women, who do not spend their entire career with a single employer. Cash balance plans treat all workers alike, regardless of age. Cash balance benefits provide portable benefits that grow steadily over time in a fair and equitable manner.

We urge the Departments to act promptly to strengthen the private pension system by dispelling the erroneous impression created by the OIG Report and by creating a regulatory environment that fosters the creation and continuation of cash balance and other hybrid plans that meet employees needs. Specifically, we ask the Departments to revoke both Notice 96–8 and the OIG Report.

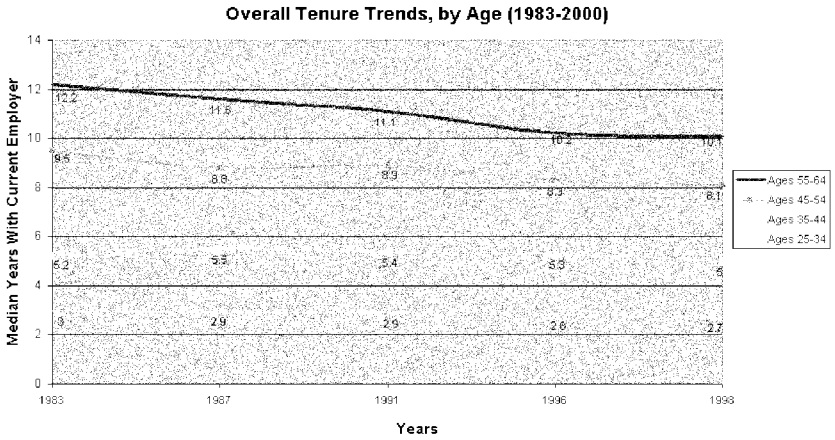
If we can provide you with any additional information or analysis that will help you and your staffs to address the issues we have raised, please let us know.

Because of the seriousness and magnitude for the issues we have raised, we respectfully request the opportunity to meet with each of you in the near future to discuss the issues further.

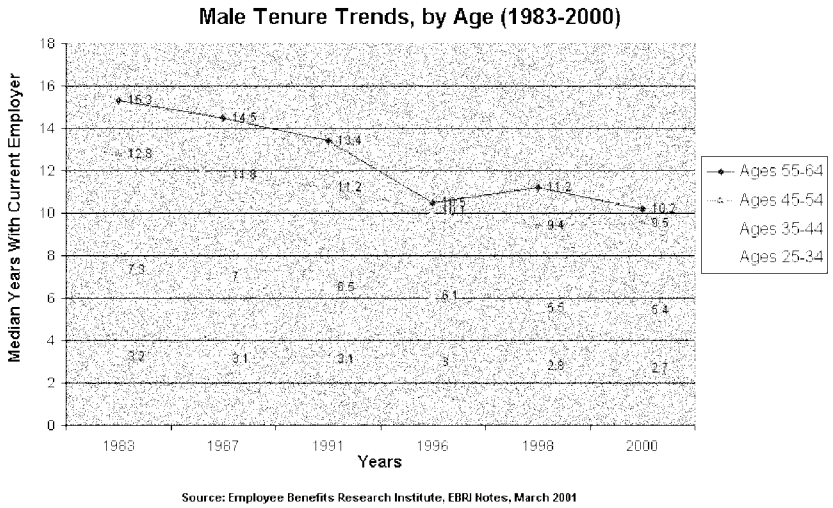
Sincerely,

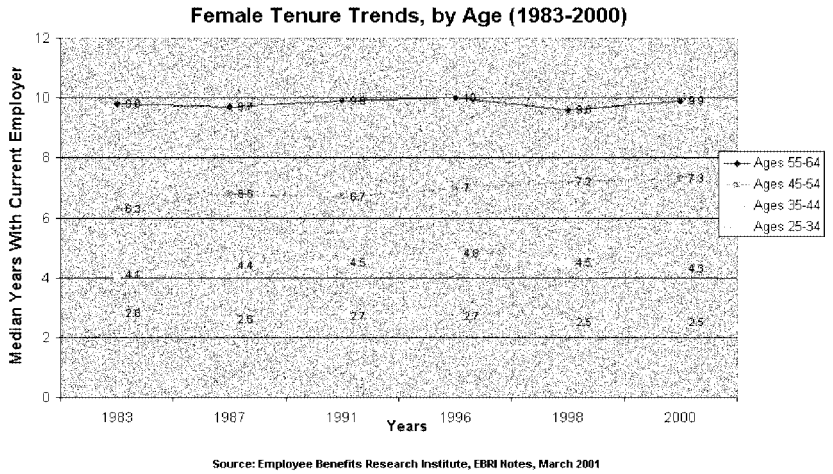
Mark J. Ugoretz
President

cc: Ann L. Combs (Assistant Secretary for PWBA—Labor Department)
Pamela F. Olson (Acting Assistant Secretary for Tax Policy—Treasury Department)
William Sweetnam (Benefits Tax Counsel—Treasury Department)
Elliott P. Lewis (Acting Deputy Inspector General for Audit—Labor Department)



Source: Bureau of Labor Statistics, U.S. Department of Labor





Chairman HOUGHTON. Well, thank you very much. Now, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Ms. Friedman, in your testimony you note that the 2001 Pension Reform Bill may have made 401(k)s so attractive to better off employees that it will be easier for employers to reduce costs by cutting back on the defined benefit plans in favor of the do-it-yourself arrangement. Could you elaborate on your statement?

Ms. FRIEDMAN. Well, yes. The incentives that were put into the Economic Growth and Tax Reconciliation Act of 2001 (EGTRA) would essentially increase limits for 401(k) plans, yet even before

the passage of EGTRA, only 5 percent of those participating in 401(k) plans could afford to put in the maximum.

So, our concern is that yes, this might create some new plans, but it is not going to trickle down to rank and file employees. So, our concern in general with EGTRA, although I certainly applaud Congress for taking steps to address the coverage issue, is that we feel that a lot of the provisions in EGTRA are going to benefit high-income employees primarily.

Since the majority of both tax preferences and also pension benefits accrue to the highest paid workers in this country, we would like to see incentives for rank and file workers. So, I guess our position would be that we should hold off and we would encourage Congress to hold off from making those provisions permanent until we see whether or not they have their desired effect of helping rank and file employees.

Also, just in terms that I did not answer your question fully, that if employers are finding 401(k)s that much more advantageous, it is a disincentive to set up defined benefit plans.

In the wake of Enron, I would say that more and more employees do understand the importance of security and that I think we should come up with incentives to encourage the establishment of new defined benefit plans, recognizing that 401(k) plans are a good supplemental plan, but they are not necessarily the best way of providing retirement income to millions of American workers.

Mr. COYNE. How critical do you believe it is to have Social Security remain a defined benefit system rather than a partially privatized system, given the decline that we are experiencing in defined benefit plans?

Ms. FRIEDMAN. The Pension Rights Center takes a very strong position on that, Congressman. We feel that Social Security should remain as a guaranty defined benefit system and that the system should not be privatized because we have already seen what can happen in situations like Enron. I think that what we want is to have a strong Social Security system, especially because so many Americans depend solely on Social Security for their retirement income.

What we need to do is strengthen the private pension system. I also want to say, Congressman Coyne, that we do support your Retirement Opportunity Expansion Act. We applaud you also for putting in the refundable tax credit which will expand coverage for those low and moderate wage earners who now don't have pension plans.

Mr. COYNE. Thank you very much. Mr. Miller, do you think that we should offer defined benefit plans that are especially designed for small businesses?

Mr. MILLER. Sure. I think it is important, whatever we can do to encourage employers to adopt defined benefit plans is the way we should go. There have been some specialty plans such as the simple plan that have been enacted previously. What we found is that those plans often enticed employers that never had retirement programs before to get involved and to start sponsoring plans.

What we found is that those are stepping stones. That is a place to start. What we found is important is that we also have to have that next step for employers. So, that is where suggestions like the

DB–K program where you are encouraging employees to save for their own retirement and take responsibility for their own retirement by making salary deferral contributions and also giving the ability for and the encouragement for employers to also sponsor the defined benefit plans where there is a guaranteed level of benefits is very important. We need to move in that direction.

The cash balance concept is another step. So, while the specialized plans are an important first step, I think we have to also look at what the next steps for employers are going to be.

Mr. COYNE. Ms. Friedman pointed out that she supported the Smart Plan. Have you had a chance to review that and take a position on it?

Mr. MILLER. Yes, and we believe that that type of program does have certain limitations that discourage employers from getting involved in those plans. The ASPA has previously been supporting a different proposal, the safe proposal, which we believe has more flexibility and more ability and encouragement for employers to get involved in those types of programs.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman and thank all the witnesses for being here and for your good testimony. This is great to get it in the record. I apologize I wasn't here earlier. I was actually at the Committee on Rules trying to get a rule for the possibility of bringing up the permanent extension of the Portman-Cardin bill for tomorrow. It may or may not happen tomorrow, but it is possible. I appreciate the comments that were made by the witnesses that I got to here. Maybe Ms. Friedman and others weren't as positive. I didn't hear that.

Ms. FRIEDMAN. We applaud your efforts.

Mr. PORTMAN. Selective listening maybe, and coming late. I really appreciate the Chairman's willingness to dig into some of these issues and focus on them. I wish that when I was at Dartmouth College that Dr. Skinner had been there. I would have been an economics major instead of anthropology major. On the other hand, here I am, getting into all of your issues.

Your data is just fascinating. I hear so much information out there about the differences between DBs and DCs. The approach that we have always taken in the Portman-Cardin legislation and with Mr. Houghton's Subcommittee and Mr. Coyne and so on, is we want to encourage both.

A lot of the changes in Portman-Cardin, I think, will help with regard to the DB side. I don't believe there is any inconsistency in promoting both, particularly with regard to smaller businesses.

The date, though, that you show also reflects the fact that we do have a more mobile workforce. I guess my general question, and maybe I should direct this to Ms. Friedman because I heard you say earlier that Portman-Cardin helps the highest paid workers versus rank and file workers. I don't know who rank and file workers are exactly.

If you are focused on low income workers, which I think you are, then wouldn't you think that because most low income workers tend to change jobs more, on average they change jobs more and they have more mobility, that a pension system where they could

take the benefits with them from job to job would be more advantageous than the traditional defined benefit plan where they would not have the opportunity to vest, which is really what Dr. Skinner found out in his studies and what others have commented on.

Ms. FRIEDMAN. Congressman Portman, as I said earlier, the Center is convening now the Conversation on Coverage. In fact, we had the first stage last year. The Conversation on Coverage is a national dialog where we are bringing together business, labor, consumer groups, academics, in fact I would venture a guess that everybody on this panel participated last year and we are going to continue that.

We are looking at incentives. The Pension Rights Center takes the position that we have to have a system where there is a delicate balance between incentives for employers, fairness and adequacy for workers and we are opportunity to lots of different ideas.

At the Conversation last year there were proposals, and you will see it in our written statement, there was a proposal for new kinds of hybrid plans that jump off from the cash balance plans that exist now.

Our issue with cash balance plans is much more in the conversion and we are certainly open to having a dialog with the business community on finding new ways of creating hybrid plans. There were other proposals that were presented at the Conversation on Coverage that also took the best parts of defined benefit plans, which is the guaranteed payment, the annuitization, and paired it with some of the best features of 401(k) plans like portability and simplicity. So, we would welcome you and other Members of the Subcommittee to join us in the Conversation on Coverage as we explore these issues.

Mr. PORTMAN. Speaking as one Member of the Subcommittee, I would be happy to join in your conversation. Where I have found you all have normally come out, and I am delighted to hear your testimony today or at least your answers to the questions, because you sound more open to it, is that you have a fundamental disagreement with many of us who believe that so long as there is not a mandate that businesses offer pension plans, you do need to provide flexibility.

That sensitive or delicate balance you talk about in fact is something very important and every time we try to create more incentives, it seems to me you all have come in and said that that is not appropriate.

With small businesses offering very little in terms of pension coverage, fewer than 20 percent of businesses under 25 employees, we believe, offer any kind of coverage at all, even a set plan or a simple plan or a 401(k). It just seems to me we do need to focus on those employers and on those low-income workers who tend to work there. So, I am encouraged by your statement and would be happy to join in that Conversation.

If I could ask one question of folks in the private sector here—my time is running out—but what has the impact been of the reforms from last year? We have some data coming in that in the first 6 months there was an increase in the IRA contributions which, I guess, is good news, that in a flat economy you have about a 25-percent increase, I am told, in terms of IRA contributions.

That is one of the few pieces of good news in our economy in the last year.

The 401(k) and defined benefit numbers are more difficult for us to come by. We have some anecdotal information that is not very helpful. Can you all give us any information today as to what the impact has been thus far of the changes that were made last year through the tax relief legislation? Maybe ABC could take a shot at that. Do you all have any data for us? Okay, how about an anecdote?

Mr. MILLER. Well, I think what we have found is that with the market going in the direction that it is going, I think what employees have learned is that there is not the constant increase in their account balances. I think that the economy had people thinking that 401(k) plans were the only thing you really needed.

A lot of people, as we heard, there was a 70-percent decrease in small business defined benefit plans in the recent past. That decrease is because 401(k) plans became the way to go. While the market was doing very well, people were happy with it and were comfortable with it.

I think what we found in the last couple of years with the decreasing in the market is that people are less comfortable with just a 401(k) plan. They need that security that a qualified defined benefit plans gives them.

I think that we still have to expect that the employees take advantage of different opportunities that are out there for them to save. It is that three-legged stool concept. We can't make this work unless all those legs are there.

So, I think that the changes that have been made in the 401(k) market, encouraging people to save in the 401(k) plans to give them incentives to do that are great. What we need to do now is that next step, again, to make sure, to give people the comfort that a defined benefit plan is there that guarantees that they will have a certain level of income once they reach retirement.

We are not going to be able to get there. Right now we have half of our workforce being employed by smaller employers, but an employee of smaller employers are only one-fifth as likely to have a defined benefit plan from their employer than larger companies. I think we have to change that around. I think we have to be able to give these employees from small employers the opportunity to have the comfort that when they retire they know they are going to have a certain level of income.

I think one of the ways, as a lot of people have been saying, is the cash balance issue. I think we need clarification on the rules. We have to have the Treasury Department come out with regulations and where necessary have legislative changes in order to encourage people to use those plans because the concepts are good. That is the type of program that employees understand and they will be more comfortable.

The traditional defined benefit plan again is harder for the employees and the employers to understand. I think that the employers need to have flexibility in funding. The ironic part of funding a defined benefit plan is that the required contribution in a defined benefit plan is highest when the economy is doing badly.

So, what you are saying is, when your business is doing badly that is when we are going to require that you put in a higher contribution, but we will not allow you when you are prospering to put in additional contributions in order to give you a little cushion so that if your business does go downhill-or you start running into certain business problems or economic problems-that you will be able to use that cushion to help offset your contribution levels.

Mr. PORTMAN. I appreciate that, Mr. Miller. I don't disagree with anything you said. I would love to find out if anybody else on the panel—I've taken too much time already—has any information on the 30-year Treasury bond issue, which we are trying to get some much better guidance with regard to cash balance and maybe there's some talk about a hybrid. I agree with all that. I would love to know what the impact is of the changes last year, if anybody has any information on that.

By the way, since my time is just about up, if you have any information, you can provide it to Barbara or to me, I would really appreciate it, afterwards. We are also working with Mr. Cardin on another bill to try to simplify further and to try to come up with some other incentives for defined benefit plans as well as defined contribution plans. So, I would love to have your input on that over the next couple of months.

Mr. O'FLINN. I am sorry, Mr. Chairman, this is it.

Chairman HOUGHTON. No.

Mr. O'FLINN. Although we don't have any hard data on this, we can put some pieces together to show a major impact of the bill. For example, the 3-year vesting requirement, the 3-year CLIFF vesting, reducing the vesting from 5 years to 3 years.

My company and several large companies that I'm familiar with have over 40 percent of their employees with less than 6 years of service. So, a reduction in the vesting is an immediate benefit to many of those people and also encourages them to think in more positive terms of the plan to make their own contributions. I don't have data on the contributions.

Also, the catch-up contribution of $1,000; $1,000 is not going to make or break anyone's retirement security, but it gives us an excuse to conduct a communications campaign about contributions to the plan to this group of people who should be thinking very seriously about retirement.

So, what happens is the entire contribution plan gets reviewed by the employee because of this news and the opportunity it triggers, I think, a lot more contributions than, you know, would be attributable to the $1,000.

Mr. PORTMAN. Sorry, Earl. Thank you, Mr. Chairman.

Chairman HOUGHTON. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I was very interested in my colleague's questions and appreciate his leadership on these issues, so you could have gone all afternoon as far as I was concerned, thought you were, as well.

The questions I have of this excellent panel, I really enjoyed every presentation, as we evaluate defined benefit versus defined contribution, Dr. Skinner you are outnumbered today with your research, but some of the things that you said actually do surprise me.

One, that even low income workers will achieve a higher rate of savings under a DC arrangement than DB. Then, virtually all of them or all but 4 percent of them not contributing have other retirement savings options. I would like to just probe these a little.

First, the earnings issue. It is my understanding that for your study you used historical performance. Did you project returns going forward?

Dr. SKINNER. Yes. What we did is, we projected forward using actual rates of return from 1900 to 1990. So, that is what we sampled from. Somebody could, in theory, get the Great Depression twice. Some of the people doing badly in 401(k) plans, that is where they ended up.

Also, there were some of the plans that were out there in the 1980s, the DB plans were just pretty horrible. They weren't indexed for inflation and they had the Social Security offsets. So, these are people who had them in place and so they retired and they just really weren't worth very much. It was unfortunate, but that is what the numbers told us.

Mr. POMEROY. Dr. VanDerhei, would a measurement period—does the 1900 to 1990 measurement period have recognized analogous levels of return to what we could look forward to now going from 2002 to 2022?

Dr. VANDERHEI. Well, the extreme difficulty with doing any kind of simulation, and I am certainly guilty of this in everything I have been running, is that we have only had one snapshot of what the U.S. stock market could look like. There are a number of different ways that one can try to add that type of uncertainty into a simulation.

I certainly agree with what Dr. Skinner and Dr. Samwick did. It is one approach. Other people might go back and try to historically replicate the exact time series that has been seen, but obviously, we have only, again, had one time series to look at in this country. To the extent that that is not going to necessarily capture everything that might happen in the future, about the only way one can go around that is to come up with one's own synthetic distribution of expected rates of return.

I do believe they had done some sensitivity analysis on a number of different types of financial scenarios and I think they were rather robust.

Dr. SKINNER. If I could add to that, we also subtracted 3 percentage points, 300 basis points, from every year's stock market return and we ran it. You know, a 3-percentage point gap is a huge gap. We ended up with roughly similar medians for the DB versus the 401(k)s. Still, at the bottom, the 401(k) still did better than the DB plans.

Mr. POMEROY. You know, I'm sort of not an economist. It strikes me that that does not capture the very significant change in demographics that we are about to undergo in the next 30 years and the resulting impact that may have overall on performance of growth of the economy, whether we will see that kind of historic growth looking forward.

The other issue relative to rates of savings, I believe it was EBRI data that showed about one third were not participating in savings

and that was even when there was an employer match under the 401(k) opportunity.

Dr. VanDerhei, are you familiar with that point?

Dr. VANDERHEI. I don't believe that is EBRI data because although we have 11 million individuals in our database, they are all participants. So, we can't give you information on non-participants hence we cannot give you the participation rate.

However, I do believe that number is fairly well in line with industry studies that have been put out. Fidelity has put out Building Futures. Vanguard has put out their own publication.

There is a substantial percentage of 401(k) participants that chose not to contribute in a specific year, the important point is that that does not mean that they will not contribute ever while they are with that employer who sponsors that 401(k).

Mr. POMEROY. Right. To me it is just almost—I mean it just doesn't make sense that virtually all of the non-participants have alternative retirement savings options at work, because half of the people in the workforce today don't have any option to save for retirement at work.

The number with both the defined benefit and a defined contribution option is a third or less of those in the workforce today. So, to think that all but 4 percent, I am just not getting that.

Dr. SKINNER. I'm sorry. I should be clearer about the number. It is a percentage of the workforce. It is people who are offered 401(k)s and they don't have a DB plan or any other 401(k) or maybe their spouse has a 401(k) and they turn it down.

So, I absolutely agree with you that if you are thinking about the problem of people not saving enough, I tend to worry less about the people who are offered and decide not to take it because they may come back and contribute later. I also worry about people who are never given the option to contribute.

Ms. FRIEDMAN. Congressman Pomeroy, may I respond to that as well.

Mr. POMEROY. Certainly.

Ms. FRIEDMAN. The Pension Rights Center, one of the reasons that we are all having the Conversation on Coverage and we are looking for new designs, how do we encourage more plans, is because there is a lot of people who don't participate simply because they don't have the money to participate.

You will find that with a typical median worker. They are living from day to day trying to make all their expenses. So, retirement is a long way off. I think that is one of the reasons that the Pension Rights Center has been critical of 401(k) plans and do-it-yourself savings plans because it requires employees to put the money in first before getting a match.

Some of the proposals that came out of the Conversation on Coverage came up with ways of putting in a reverse match where an employer would put it in first and the employee could match if they have the money.

I also wanted to say to you that in terms of some great coverage statistics that might be of help, I would like to be able to submit this to the record, Dr. Alicia H. Munnell and Dr. Annika Sund1n from the Center for Retirement Research did this very good piece for the Conversation on Coverage called "Private Pensions: Cov-

erage and Benefit Trends." I would be happy to give you a copy and also submit it into the record.

Mr. POMEROY. I am familiar with their work. It is excellent. We should have that in the record.

[The information is being retained in the Committee files.]

Mr. POMEROY. Dr. VanDerhei, did you have a response on that last point about the—you look like you were going to say something. I just want to make that opportunity available to you.

Dr. VANDERHEI. The only thing that I wanted to add, which I think, may go part of the way to explain your sense of disbelief in perhaps some of these results, is that we have found in our simulations, and it is very critical what you assume as far as participation in subsequent jobs.

We talked a lot about job mobility today. If you assume that somebody who is in a 401(k) plan today always remains in a 401(k) on each subsequent job, obviously, the defined contribution scenario looks a lot better than if you go back and say with each additional job there is perhaps a 50-percent chance of being employed by an employer that offers one and then whether or not they are going to have the type of matching formula that is going to provide incentives for them to continue to contribute.

Mr. POMEROY. Do you have data on rollover? There was a statistic that was really horrifying about the number of distributions not rolled back into an IRA. Do any of you have data on that?

Dr. VANDERHEI. Well, both Hewitt and Fidelity make that information available. I would be glad to send it to you. It is largely a function of account balance size, the larger the more likely it is to be rolled over. The smaller, the more likely to be cashed out, and also age, the older you are.

Mr. POMEROY. Dr. Skinner, I don't mean to sound like I am picking on you. You made a very clear statement that annuities could play a very important role in achieving long-term retirement income security and I think advanced a very constructive notion of default annuitization or something to try and get those selecting that option up.

I agree with you on that. I don't mean in place of DB plans. I don't mean in any way to condemn DC plans. I just want us to be very clear eyed about whether we are achieving the kind of rates of savings as well as advancing sufficiently worker expertise in terms of matching assets to expected longevity coming upon retirement to achieve the overall goals of retirement income security that we need. All of you are leaders in this area. It has just been my joy to work with you. We have a lot of work ahead. Thank you very much.

Chairman HOUGHTON. Okay, I have one final question. Now you are all a Board of Directors, okay? We are part of the Portman-Pomeroy Corp. and we are deciding what sort of pension plan we would have for our employees.

Maybe you could just sum up very briefly what your pension plan basically would be and if there are necessary changes in the law in order to make this thing more palatable, salable. Let's start with you, Mr. VanDerhei.

Dr. VANDERHEI. Under the current scenario, I would certainly go with a hybrid approach, not cash balance hybrid, but a combina-

tion of defined benefit and defined contribution. If you are asking what is the one recommendation I would suggest, it is something that Ron has mentioned and several others. It is the addition of a 401(k) salary reduction feature for defined benefit plans.

I did a study for the Labor Department in the early eighties as a result of the reversion phenomenon and in 80 percent of the plan sponsors that I interviewed that had reverted their defined benefit plan, it was to go into 401(k) plans because that is all they were hearing from their employees is this great opportunity for salary reduction. They could not offer it through the defined benefit vehicle, so they decided to terminate altogether.

Chairman HOUGHTON. All right. How about you, sir?

Mr. GEBHARDTSBAUER. I am going to be like an actuary and say I need to have more data. I would need to know what kind of industry I was in. Is it an industry where employees are going to be around for a long time or they are going to be more mobile, industries where people are around for a long time like in the government or in multi-employer organizations or big organizations—

Chairman HOUGHTON. It is a service organization and we are in a very mobile society.

Mr. GEBHARDTSBAUER. Okay, thank you. Well, as some people have already talked about, I also like the hybrid or DB–K idea which brings in the 401(k) idea into the DB world and if I could design it without the way the laws are in the United States, you could have pre-tax contributions and matches from the employer, so it would look like the 401(k) to the employees.

I can design that in a DB context so it will look exactly like a 401(k) to the employees or a cash balance plan to the employees, but I (the employer) also get advantages. In fact this is in reference to Professor Skinner's point before. I can make it look just like the DC plan and get the same kind of returns as he is talking about.

If I have it in a DB world, then as an employer I have funding flexibility. I have investment flexibility. I have flexibility to design it in ways every once in a while if I want to have an early retirement window, I can put that in.

So, in a DB world we have more flexibility. In the 401(k) world, you just get whatever is in the assets. There can be periods, for instance, when the assets of a 401(k) will go down and none of your employees will want to retire. So, that can cause difficulty in my workforce management area.

So, I like the 401(k) idea. I like the DB idea. If we can put them both together, I can create something with enough flexibility that not only is it good for me, by the way, but it will also be good for the country, too, and the employees, because benefits then can come out in the form of an annuity. They will like it. It is also good for the country because it reduces poverty levels for very old Americans, too.

Ms. FRIEDMAN. I guess it is my turn. I guess that we would say taking the best of the DB world, the defined benefit structure and the defined benefit plan. I am thinking here that your corporation is probably on the relatively small side.

The most important thing to the Pension Rights Center would be fairness, so the same percentage of pay contributed for all employ-

ees. Make sure that the benefits will be annuitized, that they would be insured so that people wouldn't lose out.

There could be some sort of a salary reduction feature. We would also like to see a reverse match, as I said before, where an employer put in first, and then the employee could match that and also pooled investments to ensure that we don't end up with another Enron, and we have secure retirement. I think that would be my pick today.

Chairman HOUGHTON. Thank you. Doctor?

Dr. SKINNER. I think I would not surprisingly go with the——

Chairman HOUGHTON. Don't forget, you have a Dartmouth fan up here.

Dr. SKINNER. I know, a very distinguished graduate.

No, I think I would go with a 401(k) plan where I would make a strong effort to educate the workers that if they wanted a safe investment that there was an option for inflation adjusted Treasury bonds which would basically be as sure as anything there is.

I think this would give firms less flexibility, but it would also give them less flexibility to dump their pension liabilities onto the PBGC, which would probably be a nice thing, too. Thanks.

Chairman HOUGHTON. Thanks very much.

Mr. Miller.

Mr. MILLER. Not surprisingly, I would be in favor of a DB–K program where you take the benefits of both a 401(k) and a defined benefit plan. One of the important changes in the law would be to change the law to allow you to have both those types of programs within the same plan so that you can reduce the administrative costs.

The second thing would be to, just like we have certain safe harbor contributions within a 401(k) plan, within our DB–K program you would want to have some type of comparable safe harbors in order to let the employees know in advance what level of contributions they will be able to make into the plan while guaranteeing all employees a certain baseline level of benefit.

You would need to make certain changes to the deduction limitations. Right now the way it is is that you can, because of the way the deduction limitations are when you have a defined benefit and a 401(k) plan, with a defined benefit plan you might be in a position after making that contribution to not be able to make a contribution and take a deduction within a 401(k) plan.

We have to change the laws so that matching contributions, even though defined benefit plan contributions are being made, the employee could still make and take deductions for matching contributions and basically allow the employer to make matching contributions by matching it through defined benefit accruals in order to again increase the guaranteed level of benefits that the employee could rely on.

Chairman HOUGHTON. Okay. Mr. Beilke.

Mr. BEILKE. Yes, as was said before, of course, more information on objectives is always important. What are we looking at with our own employees here? Are we looking at an isolation that we have come to a conclusion that we want to provide a certain amount of retirement income or are we constrained by the amount

of financial commitment that we can put toward this and what kind of competitive environment are we in?

You know, if we do something very light, is everybody going to run to our competitor because they have something better? If we do something good, are we putting ourselves out of business and spending too much?

All those things have to be taken into account. Once we have taken those into account and defined all those things, I believe that, my personal recommendation would be two plans. One of the defined contribution nature and one of a defined benefit nature. The reason why is we have the older, long service employees already who have not been in a plan until now, if this is the first time we are putting a plan in. We cannot expect them to buildup enough for retirement in the short time period that they still have left. Only a defined benefit plan can provide benefits for the service that they have already provided to us.

On the other hand, the defined contribution plan, with this mobile workforce that you mentioned, is very attractive to them and very important to them.

So, you have to balance the needs of our executives, Representatives Portman and Pomeroy, and their needs to provide retirement income for themselves when they retire and the younger employees that come and go.

As far as what law changes would be needed to make this go forward easier, certainly the 30-year Treasury bond and the amount of volatility that is going to cause us because we would be so underfunded in that defined benefit plan in which we gave past service.

We start right out with unfunded liabilities. As we go into funding this, the funding rules right now could cause us to jump all over the place in early years of how much we had to fund that and not know what the commitment really is as we walk into this, which we really should do in a fiduciary manner of knowing where this is all going.

Certainly, going back to Mr. Portman's earlier question of what did this law just do, I think it changed the attitudes out with us in trying to put in new plans. Now that we see Congress realizing that the laws of the eighties and nineties which always constricted what we could do, made it more complicated, the law last year finally is the first step in a turnaround in that fashion of trying to simplify some things and also to expand issues that allow more coverage.

Seeing that mindset change gives us more good feelings about what is going to happen in the future in that we don't jump into this and see a bunch of laws like we saw in the eighties, that we would be much more open to putting in plans that do require a good financial commitment in the future without being worried about being hit with law changes that completely change what we are doing every year down the road.

Chairman HOUGHTON. Thank you very much. Finally, Mr. O'Flinn.

Mr. O'FLINN. Mr. Chairman, in the hypothetical you outlined with high mobility, I think we would clearly select a cash balance plan together with a 401(k) plan. The ERIC companies are large

companies with a heavy commitment to benefits. So, there are many of them who, for competitive reasons, and of course they would want to match the competition, would be forced to put in a tradition defined benefit plan.

So, all of the problems that come with that, including the volatility in the funding, would be a consideration and they would need to address that.

I would add one thing that hasn't been mentioned. That is that I would want the ability to put in a comprehensive education program. Some of the things that Congressman Pomeroy referred to would not happen. People would make informed and presumably better decisions.

Although those programs are very common, they are not without legal risk. It would be wonderful to have a clear legal pathway to educate employees appropriately so that they could make informed decisions that would affect their financial security.

Chairman HOUGHTON. Well, thank you very much. That is a fascinating idea. I wish I could be a Member of this corporation to continue this discussion. Thank you very much for your contributions. The hearing is adjourned.

[Whereupon, at 5:00 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Women's Institute for a Secure Retirement, Cindy Housell, statement and attachments

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Duluth, Georgia
July 5, 2002

To: Subcommittee on Oversight of the Committee on Ways and Means
From: Fred Munzenmaier
Subject: Comments to the Subcommittee on Retirement Security and Defined Benefit Plans

I am submitting these comments on my own behalf as a private citizen.

My comments are as follows:

Defined benefit plans have been a cornerstone of our National retirement income policy for the better part of the twentieth century. The significance of these plans to the financial security of our retired population is exceeded only by the importance of Social Security.

As you know, in recent years there has been a trend away from defined benefit plans in both the private and public sectors. The smaller the employer, the more likely that a defined benefit plan has been terminated or not considered at all.

Your Subcommittee will hear comments from commentators that 401(k) plans and other forms of defined contribution (DC) plans are more portable and better suited to today's mobile workforce. Defined contribution plans no doubt play an important role in the overall retirement scheme.

As workers with only a DC plan actually retire, however, they must cope with fluctuations in the capital markets during their retirement years—unfortunately there is a proclivity to focus only on managing DC accounts before retirement. When one has to factor in the cash flow needs in retirement, the weakness of sole reliance on DC plans is exceedingly evident. Consider what happens when a retiree must liquidate investments at a down point in the market just to meet current cash flow needs. Most people are not equipped to manage these inevitable situations.

Nowadays, capital markets are not only influenced by economic factors (which make managing a defined contribution arrangement difficult enough), the markets are influenced by the degree of integrity (or lack thereof) of corporate leaders.

All things considered, those workers without a defined benefit pension will wish they had one.

In spite of the platitudes your Subcommittee will hear about why there has been a decline in defined benefit plans in favor of the more trendy DC plans, the primary reason for the decline is much more subtle. The decline is tied directly and indi-

rectly to our system for guaranteeing pensions, i.e., the system embodied in the Pension Benefit Guaranty Corporation (PBGC).

Your Subcommittee and the Nation must ask a basic question as follows:

> Is our current system of guaranteeing defined benefit plan benefits (i.e., the PBGC) synonymous with the protection of American workers' pensions?

The PBGC reports that 644,000 people have guaranteed benefits from plans that have actually terminated. In 2001, there were 44 million workers in plans covered by the PBGC. Assuming there were at least that many (DB coverage has been declining) in each of the 25+ years of the PBGC's existence, is 644,000 out of 1.1 billion man-years (44 million times 25 years—yielding a 6 in 10,000 chance to benefit) a sufficient return on our investment in the plan termination system?

I submit to you that for every defined benefit plan participant who got a PBGC guaranteed benefit, there are many more who never had a chance for a pension because their employer is not willing to subject company operations to the fits and starts that have been created by our current pension funding rules that are driven by concerns about the PBGC's financial condition.

In fact, it is against the PBGC's interests to insure terminating plans. Each terminating plan that the PBGC must assimilate hurts its financial position. Over the years since ERISA, I have attended pension industry meetings where PBGC representatives were speakers, and I had a personal interview with the first Executive Director of the PBGC. It has always astonished me that the first concern of the PBGC officials is for the financial status of the PBGC. The protection of workers' pensions did not seem to be on their first priority.

The problems began with the flawed concept in ERISA but have been multiplied many-fold by subsequent pieces of legislation designed to protect the PBGC. Specifically, OBRA 87 and RPA 94 imposed absurd funding requirements that must be met by private sector employers.

The system is flawed in other ways, too. Besides the ridiculous funding requirements, the PBGC has carte blanche to meddle in the business affairs of any corporation that sponsors a defined benefit pension plan. The PBGC has a unilateral right to step in and terminate any private sector retirement plan that it chooses.

The premiums that employers must pay to the PBGC started out in the 1970's at $1 per participant. The premiums are now $19 plus a "variable premium" based on ultra-conservative rules that actuaries must use to measure plan's unfunded vested benefits. To many employers, the PBGC variable premium can be hundreds of thousands or millions of dollars even though the plans are in fact well funded according to the calculations of the Enrolled Actuaries who serve the plans. The under-funding exists merely because of the bizarre assumptions mandated by the OBRA 87 and RPA 94 legislation.

As a result, too many responsible business leaders have been forced to avoid defined benefit pension plans. Corporate governance responsibilities dictate such decisions in spite of the good that defined benefit plans could do to provide retirement security to their workers.

In closing, I suggest that the Subcommittee call for a report by the General Accounting Office on whether the current system for guaranteeing pensions in this Country has been worthwhile or whether the time for the PBGC has come an gone. This report might also cover methods to protect workers covered by DC plans (401(k) plans) in the aftermath of recent corporate accounting scandals.

Respectfully submitted:

Fred Munzenmaier

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