TESTIMONY OF
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THE ERISA INDUSTRY COMMITTEE

BEFORE THE
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET AND INTERNATIONAL SECURITY
COMMITTEE ON GOVERNMENTAL AFFAIRS
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Safeguarding America's Retirement Security: An Examination of Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to present the views of The ERISA Industry Committee on the funding of defined benefit pension plans. I am Christopher W. O'Flinn, Vice President, Corporate Human Resources, AT&T Corporation and Chairman of The ERISA Industry Committee (ERIC), on whose behalf I am speaking today.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, 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 cost and effectiveness, and the role of those benefits in the American economy.

All of ERIC's members sponsor 401(k) and other defined contribution plans. But we are unique in that almost all of the ERIC membership also sponsor defined benefit pension plans. Our members also pay the bulk of the premium-taxes collected by the Pension Benefit Guaranty Corporation (PBGC). Thus we have a very strong interest and concern in both in the vitality of the defined benefit system and in maintaining a strong PBGC. Time and again we have come forward with proposals for reform of the defined benefit system, frequently providing the basis on which the government could forge a consensus to resolve important issues. We work to understand this complex system and to try to share our perspective with thoughtful legislators like yourselves.

SUMMARY STATEMENT

The Subcommittee asked ERIC to address (1) the financial status of the Pension Benefit Guaranty Corporation, (2) the financial status of private sector defined benefit plans, and (3) specific proposals for reform aimed at either or both of the first two issues.

The defined benefit system is a voluntary system. No employer is required to sponsor a retirement plan. The Subcommittee's investigation is important and timely. If the public policy issues under consideration are not properly evaluated and resolved, the voluntary system will be undermined and millions of American workers will face retirement without a secure, defined pension benefit in their portfolio.

The Pension Benefit Guaranty Corporation (PBGC)

Is the PBGC in trouble?

The PBGC has issues that at some point should be addressed. For example, the current procedures regarding PBGC guarantees of shut down benefits have unsatisfactory results for both participants and for the PBGC. A review of the entire benefit guarantee structure also is in order, and we also are examining the PBGC proposals to expand current law provisions that stop severely underfunded plans from increasing benefits.

While the system can be improved, a close look indicates that the agency is not in trouble, however. The Subcommittee should monitor the financial status of the PBGC, but should recognize that the PBGC's funded ratio is higher than it has been for most of its existence. It appears readily able to weather the recent economic slowdown. Let me explain this point of view in more detail because it is important.

First, much has been made of the PBGC's current deficit, but the economic health of the PBGC is determined not by whether it has a surplus or deficit at any point in time but by its ability to pay benefits over a long duration to participants of plans it trustees. Moreover, the loss of the PBGC's surplus should not be a surprise in the current economic circumstances. It is, in itself, not a cause for alarm and can be expected to ameliorate as conditions improve.

In this regard, I want to make clear that ERIC supports a strong PBGC. Indeed we have everything to lose from a weakened or troubled PBGC since plan sponsors, not the taxpayer, will face higher premium taxes.

The truth is, PBGC has sufficient assets to pay benefits for the foreseeable future. In fact, the PBGC has operated successfully with a deficit for most of its history. Unfortunately, testimony by the PBGC before the House Education and Workforce Committee on September 4 overstates the challenges it faces. Not only does this make it difficult for Congress to respond appropriately, it discourages employers from establishing and maintaining defined benefit plans, undercutting PBGC's future premium base.

The Subcommittee should pursue several questions in order to attain a better understanding of the long term viability of the PBGC – questions to which we, too, would welcome answers. Based on the answers to these questions, Congress, the PBGC, and plan sponsors can proceed to devise appropriate responses. Specifically,

1) Rather than focusing on temporary deficits and surpluses, the Subcommittee should ask the PBGC to provide data and analysis regarding the program's funded

ratio (assets divided by liabilities) as well as its long term cash flow under various scenarios in order to determine whether the agency indeed has a short or a long term problem.

2) Since the PBGC does not purchase annuities, the Subcommittee should require and examine analyses of the PBGC liabilities using discount rates other than the PBGC-constructed annuity rate.

3) The Subcommittee should examine the impact of average claims over time on the agency rather than focus on periodic spikes in claims caused by temporary market conditions, especially since the PBGC neither pays lump sums nor purchases annuities.

4) The Subcommittee should work with the PBGC to develop a more consistent mechanism for including "probable" terminations – i.e, terminations that have not yet actually occurred – in its surplus and deficit calculations. And it should work with the PBGC to ensure that information regarding "possible" future terminations is developed on a sound basis and is presented in a way that it will not be confused with actual or probable claims.

The PBGC may well face issues that should be addressed, but there is ample time and resources to address them. A short-sighted focus on swings in PBGC's surplus and deficit merely drives premium payors away from the defined benefit system – which is what is happening now.

The real security of the PBGC lies not in imposing new rules that force cash-strapped companies to choose between growth or even survival and putting more money into their pension plans. It lies in fostering a vibrant system with lots of companies maintaining defined benefit plans on which they pay premium taxes to the PBGC.

The Status of Private Sector Defined Benefit Plans

The primary crisis facing private sector defined benefit plans is not a snapshot picture of their funded status at the end of a difficult economic downturn -- the issue that has received the most attention in the press. The primary crisis facing defined benefit plans and the employers who voluntarily sponsor those plans is the failure to date of the government to enact a replacement for the defunct 30-year Treasury bond for pension regulation, especially the use of the 30-year bond as the discount rate mandated to calculate a pension plan's current liability.

Replacement of the defunct 30-year bond is not "relief." It does not relieve a plan from its legitimate funding obligations. Underfunded plans will still be required to speed up cash contributions to their funds. Replacement of the 30-year bond rate simply places funding requirements on a rational standard.

Why is action on this issue so urgent? Why isn't December, or sometime next year, time enough to act?

The lack of a permanent and rational discount rate in the law subjects plan sponsors to enormous unnecessary cash calls and debilitating uncertainty. Companies are today implementing their 2004 budgets and determining their likely business plans for 2005 and beyond. Business and financial planning does not occur in a vacuum nor is it established in a last-minute, crisis mode. Companies cannot afford to assume what Congress might do at some point in the future. They are instead delaying business expansion, moving jobs off shore or eliminating them, or even going into debt to secure their operating cash. Credit raters and stock analysts are today examining companies' future cash flows. They want to know whether the company can withstand the enormous cash calls that will hit companies if Congress does not act. They are looking at projections three, four, and five years into the future based on the defunct 30-year rate. Stock prices and credit ratings have decreased based on those projections.

No business can tolerate this type of irrationality for long. Icon U.S. companies, some of whom have sponsored defined benefit plans for fifty years or longer, are re-examining their commitment to the defined benefit system. I am aware of some that already have frozen their defined benefit plans to new entrants.

In this environment, the government has an overwhelming obligation to enact – now – the widely-accepted composite corporate bond rate as a replacement for the 30-year bond. Then it can turn its attention to the need to rebuild our defined benefit system.

Regarding the funded status of the defined benefit system, while year-end 2002 reports indicated a higher level of underfunding than the previous year, this is primarily a result of decreases in interest rates. Up-to-date 2003 reports indicate the funding dip already is being reversed. What this tells us is that the so-called funding crisis is instead a cyclical phenomenon that is very likely to correct itself. It should be monitored and examined, but it is not a cause for drum beating or the formulation of major new public policy.

Proposals for Reform

If defined benefit plans are to be a vital component of retirement income security for American workers and their families in the future, the government must act in a thoughtful and helpful manner to create an environment that encourages rather than discourages responsible participation by employers in the retirement system. ERIC proposes that proposals for reform be tested against the following principles:

1) REPLACING THE 30-YEAR BOND. The most important single action the government can take is immediately to enact legislation that replaces the defunct 30-year Treasury bond with a composite of high quality, long term corporate bond indices for purposes of pension regulation.

2) VOLUNTARY SYSTEM. The U.S. pension system is voluntary. Employers are not required to offer employees a retirement plan. To create a robust system, more than neutrality is required from the government. The government must

make it clear to employers that it supports them when they offer retirement plans – including defined benefit plans – to their employees.

3) COORDINATION. ERISA is a reticulated statute. It is critically important that reforms not be enacted in a piecemeal basis. This especially applies to the Administration's proposals to change the structure of liability calculations to incorporate duration-adjusted discount rates and its proposals to add additional disclosure requirements on top of the existing confusing scheme.

4) LONG TERM COMMITMENT. Pensions are both funded and dispersed over a long period of time. While short term, or spot measures such as the yield curve proposed by the Administration may produce a more precise point-in-time estimate of plan liabilities than is obtained under current law, it is not at all clear that such measures produce a more accurate measure of the plan's ability to meet its obligations over time. Spot measures of pension liability and funding requirements based on such measures can result in volatile cash calls on the company while the goal of future reforms should be instead to reduce the volatility of funding requirements. In addition, we note that it makes no sense to describe the funded status of an ongoing plan in terms of its "termination liability," as has also been proposed by the Administration. Publishing such calculations will lead people to believe that plans will terminate when they are not terminating. After a period of time, when the plan doesn't terminate, people will discount this information, as well as important information provided elsewhere.

5) CHANGING WORKFORCE. Even in plans with a preponderance of retirees, benefit payout typically is a long-term commitment – over ten to twenty years or longer. Thus proposals to impose different (duration adjusted) measures of liability on plans with a preponderance of retirees may unnecessarily impose additional burdens on those plans. To address the modern pension system effectively, the government should instead focus on providing much-needed regulatory certainty for innovative hybrid defined benefit plan designs created to meet the profile of today's more mobile workforce.

6) DISCLOSURE. Disclosure rules should be considered separately from funding requirements. Disclosure should provide the employer, participants, and the investment community relevant, helpful, and timely information concerning the long-term viability of the company's pension plan. Recent Administration disclosure proposals, which rely on harsh and unrealistic measures, appear instead to be designed to force companies to speed up contributions to plans far beyond what is necessary to meet liabilities over time in the future. This causes several adverse repercussions: scarce employer cash is diverted (typically at the bottom of a business cycle), investors are discouraged from investing in companies that offer defined benefit plans, employers are discouraged from maintaining a defined benefit plan at all, and, as a result, the PBGC's premium base is further weakened and concerns about the long term health and vitality of the retirement system are aggravated.

7) REWRITE V. AMENDMENT. Unlike the situation in 1987, there is no current need for a major overhaul of the pension funding rules. In 1987 ERIC recommended the creation of special funding rules to speed up the flow of cash to severely underfunded plans. Today, in general, the current-law two-tier funding system works well. In evaluating the progress since 1987, it is important to remember that many of the plans currently being assumed by the PBGC were accorded special transition arrangements in the law then and in the 1994 amendments. These plans were not subject to the more rigorous funding rules for the entire period since 1987. At the same time, the funded status of plans that the PBGC is assuming has improved. Prior to 2001, 41.3% of PBGC claims arose from plans less than 25% funded at termination. In 2002, PBGC indicated that the cumulative percentage of claims terminating less than 25% funded had declined to less than 30% of claims. (see Table S-13, PBGC's "Pension Insurance Data Book" for 2001 and 2002). Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform. It does not. Some modifications could be considered to improve the current rules to increase the attractiveness of defined benefit plans to employers.

8) FLEXIBILITY. Current law disincentives to funding should be removed. Current law restricts deductions for funding and the timing of contributions. It imposes excise taxes if a company funds up its plan over set limits. Future rules should provide additional flexibility regarding the ability of an employer to fund the pension plan whenever the company has extra cash, should provide full deductibility of contributions made, and should eliminate excise taxes on contributions to plans.

9) BENEFIT GUARANTEES. Current law provides different rules for plans that are fully funded and for plans that are less than fully funded. There has been no similar examination of what guarantees should apply to plans terminated with insufficient funds. It would be appropriate to reconsider an appropriate guarantee scheme based on our over 25 years of experience with the current system.

OVERVIEW OF THE DEFINED BENEFIT SYSTEM

Define benefit pension plans are an essential part of retirement income security for approximately 42 million U.S. workers and their families. Under typical defined benefit plans –

- Participation is automatic; employees do not have to make an election or reduce their wages in order to accumulate retirement savings.

- Unlike defined contribution plans, the employer shoulders the investment risk; and, for most participants, benefit amounts are fully guaranteed by the Pension Benefit Guaranty Corporation.

- Benefits under a defined benefit plan can be adjusted to reflect changing economic circumstances or business needs more efficiently than under a defined contribution plan. For example, under a defined benefit plan an employer can provide full benefits to employees prior to the normal retirement age through "window" plans; or an employer can provide past service credits as part of a benefit increase.

- Plans must offer an annuity payout, ensuring that retirees do not outlive their savings and providing critical survivor protections.

- The reliability of payments from a defined benefit plan reduces pressure on government programs such as social security.

- The over $1.6 Trillion held in defined benefit pension trusts is an important source of long-term investment in the nation's economy.

Whether defined benefit plans continue to be available on a wide-spread basis in the future, however, is an open question. While the workforce has grown, the number of participants in defined benefit plans has remained relatively constant and the number of plans offered has dropped dramatically. The number of plans insured by the PBGC has dropped from 112,000 in 1985 to 30,600 in 2002.

- Beginning in the early 1980's layer upon layer of burdensome regulation, often overlapping and sometimes contradictory, were heaped upon defined benefit plans. This trend was only recently reversed in bipartisan pension reform bills, but the task of imposing only necessary, rational, and workable rules on defined benefit plans is far from done.

- Government regulation prevents a company from putting extra funds in its plans during favorable economic times and imposes harsh funding requirements during economic downturns. It over-relies on mandated and point-in-time measures of liability that result in volatile funding requirements that are unworkable and unacceptable in a business environment.

- Government regulation has failed to support innovation in defined benefit plan design. For example, while hybrid plan designs have been in existence since the mid-1980s, the government only now is attempting to provide an appropriate regulatory framework for these plans, which have enabled employers to extend meaningful benefits to American workers throughout their careers and regardless of their career choices. The absence of guidance has inhibited expansion of pension coverage, caused confusion among the courts, exposed plan sponsors to unnecessary litigation, disruption, and adverse publicity, and created uncertainty among plan sponsors and participants.

- The United States is lurching toward the retirement of the largest demographic group in its history with no national retirement policy in place. Reforms are proposed and enacted (and thereafter often changed) piecemeal, with no

consideration or knowledge of their impact on the long term retirement security of its citizens.

Today, defined benefit plans are under unprecedented pressures: volatile and harsh contribution requirements triggered by a unique economic cycle and an inappropriate statutory standard, a barrage of unfavorable press reports, and widespread exposure to litigation paired at least in part with an absence of regulatory clarity in key areas. These pressures clearly discourage employers who want to provide a retirement plan for their employees from adopting or retaining a defined benefit plan.

What the government does in the coming weeks will tip the balance one way or the other – toward a vibrant retirement system offering individuals both defined benefit and defined contribution options or toward a more narrow system that relies almost entirely on plans where the employee bears the investment risk and that saddles the nation with reduced amounts of secure retirement income for future retirees and increased pressure on government programs.

In short, the health and vitality of the nation's private retirement system and accordingly the retirement security of millions of American workers is at stake in the current debate and analysis over funding and other reforms.

HOW THE SUBCOMMITTEE SHOULD ADDRESS ISSUES FACING THE PENSION BENEFIT GUARANTY CORPORATION

What is the PBGC?

One of the primary aspects of a defined benefit plan that makes it attractive to employers and employees alike is its stability. Employees count on the fact that benefits they have earned to date will not be reduced by amendment or fortune. Even if a plan sponsor goes bankrupt and leaves an underfunded plan behind, employees' pensions, up to certain guarantee levels, are protected and paid by the Pension Benefit Guaranty Corporation (PBGC).

The PBGC operates like a very large pension plan – not like an insurance company. When it trustees a plan, it assumes management of the assets of the plan's pension trust and it pays benefits directly to participants from the accumulated assets of the plans that it trustees, much like a large, ongoing pension plan. It does not purchase annuities from insurance companies. It invests and earns money on the assets it holds. In addition, all of the PBGC's obligations are paid out over decades because it does not pay out lump sum benefits.

An insurance company has only one chance to collect money to fund annuities it pays as well as to secure its own profits – the point in time when the purchaser buys the annuity. The PBGC has additional sources of revenue. It seeks additional funds from the companies of plans it trustees. It also collects about $800 million a year in premium tax

revenue from defined benefit plan sponsors. In addition, the PBGC does not need to make a profit and has greater latitude than an insurance company to invest in equities.

The PBGC also has authority to borrow money from the U.S. Treasury. However, this is a very unlikely occurrence. If the PBGC needs more money, the most likely occurrence will be a hike in the PBGC premium tax paid by my company and other sponsors of defined benefit plans.

What is the PBGC's financial status?

The current financial status of the Pension Benefit Guaranty Corporation (PBGC) should be monitored by Congress, but does not require any action this year. The PBGC's funded ratio still is stronger than it has been for most of its history, and the corporation is abundantly able to pay promised benefits to participants in plans it trustees for the foreseeable future.

Reports that the PBGC "could be the next S&L crisis" are irresponsible and harmful to the defined benefit system. First, unlike with an S&L, there can be no "run on the bank" in plans maintained by the PBGC. Individuals can collect benefits from the PBGC only after they meet the eligibility criteria and then only as annuities paid out over time. Second, even if the PBGC were to trustee several large additional plans, they would still be able to pay benefits for a very long time. This is because they receive the assets of the plans up front – but pay benefits only over decades. Thus, even if the current deficit of the PBGC were to further spike it would be on top of a much higher asset base.

The health of the PBGC is determined not by a short-term surplus or deficit but by its ability to pay benefits over the long haul. The loss of the PBGC's surplus should not be a surprise in the current economic circumstances and is, in itself, not a cause for alarm. Indeed, given the requirement of ERISA (Sec. 4002) that the PBGC "maintain premiums established by the corporation…at the lowest level consistent with carrying out its obligations under this title," maintaining a surplus might be in violation of the corporation's charter.

Current analysis, which tends to be very short sighted, does not tell us enough to answer the question of the PBGC's long term viability with confidence. The health of the PBGC should not be judged by its funded status at a point in time using spot interest rates. The Social Security system, for example, examines its ability to pay benefits for 75 years into the future. While we are not recommending a 75-year projection for the PBGC, there are several things that could be done to help this Subcommittee, the Congress, and us, the premium payers, gain a better understanding of the actual status of the PGBC.

On what should the Subcommittee focus?

First, several statements recently made by the PBGC should be clarified.

- The corporation's September 4 testimony before the House Education and Workforce Committee fails adequately to take into account recent improvements

in the economy. The testimony retains an estimate of total underfunding in the single-employer DB system of $400 billion as of 2002 – and fails to acknowledge, as have several other studies, improvements in estimates of the funded status of plans that have occurred throughout this year. Failure to update this estimate obscures the cyclical nature of the current situation and provides an unrealistic base from which to analyze the PBGC going forward.

- A similar problem occurs relative to the PBGC's July 31, 2003 uptick in the estimate of its deficit to $5.7 billion. Since the interest rate the PBGC uses lags the economy by six to ten weeks, this number fails to take into account recent dramatic changes in interest rates. In addition, as discussed below, the interest rate used by the PBGC leads to inflated liability numbers.

- In addition, while the PBGC reports an uptick in its deficit, it does not supply information regarding its funded ratio. Even after the assumption of the Bethlehem Steel plan, the PBGC had a funded ratio of approximately 90%, which is better than its first 20 years and would mean, under the ERISA funding rules, that the program was very well funded indeed for this point in an economic cycle. ERIC has asked for information regarding the PBGC's assets that would enable us to compute a current funded ratio for the PBGC, but the PBGC has failed to supply us that information. Perhaps they will supply it to the Subcommittee.

- In detailing challenges facing the PBGC, the September 4 testimony (at page 6) states that because of improvements in male longevity since 1950, plans face "an additional seven years of retirement that must be funded." The implication that there are seven years of benefit payments that are not funded is incorrect. Employers already fund plans using modern mortality tables approved by the Treasury Department. While some mortality improvements will occur in the future, there is no hidden liability that is being shifted to the PBGC.

- Finally, as explained in more detail below, the PBGC should provide more information on its funded ratio; use a more realistic discount rate; analyze claims in terms of averages over time rather than focusing on temporary and cyclical spikes; and take much greater care to distinguish between actual claims, probable claims, and possible claims so that the Congress and the public do not confuse what are in fact different numbers.

<u>The Subcommittee should require that the following steps be taken in order to adequately assess the financial health of the PBGC and in order to ensure that the financial statements of the PBGC provide the best possible information to the Congress and the public:</u>

1) FUNDED RATIOS AND LONG TERM CASH FLOW. In presenting its financials, the PBGC should place greater emphasis on its long-term ability to pay benefits than on short-term measures of surplus or deficit. Despite the events of the last few years, the PBGC can pay benefits for many years into the future. In fact, based on its 2002 report adjusted for the subsequent termination of the Bethlehem Steel plan, if the

PBGC were to receive no additional income whatsoever, it could easily maintain the current level of benefit payments for more than 10 years. With asset and premium income, that period will be longer. The PBGC has over $30 billion in its trust funds – assets acquired from plans it has trusteed as well as from premium payments. The agency has done well with its assets, earning an average of 12% a year from 1985 through 2002. As noted above, the agency had a funded ratio of 90% post-Bethlehem.

Rather than focusing on the PBGC's current surplus or deficit – which fluctuates dramatically with the economy and interest rates – the Subcommittee should ask the corporation for analyses of the program's funded ratio (assets divided by liabilities) as well as long term cash flows under various scenarios, in order to determine when the agency indeed has either a short or a long term problem or, in fact, any problem at all.

2) REALISTIC DISCOUNT RATE. The PBGC should use a more realistic discount rate in calculating its liabilities. Currently the PBGC calculates its liabilities based on a non-competitive annuity purchase rate compiled through an undisclosed basis from information provided by the insurance industry. However, the PBGC does not purchase annuities; it pays benefits from its assets much like a large pension fund. It also invests those assets and over the long term has reaped significant benefit, as do pension funds, from an equity premium.

While use of a conservative rate may be appropriate for a quasi-federal agency such as the PBGC, over-conservatism has severe costs. Overstating plan liabilities is directly harmful to participants, plan sponsors, and the entire retirement system. It results in participants losing their non-guaranteed benefits. It results in excessive premiums being charged to plan sponsors. It also fails to provide an accurate picture to the Congress of the corporation's financial health. The Subcommittee should examine the liabilities of the PBGC based on realistic rates appropriate for an ongoing enterprise rather than the PBGC-constructed annuity rate.

3) AVERAGE CLAIMS OVER TIME. In presenting information on claims, the PBGC should place greater emphasis on average claims over a period of time. The PBGC claims experience is characterized by sharp spikes that are cyclical in nature and directly relevant to temporary market conditions. Claims spikes occurred in 1987, 1991-1992, 2001-2002, and to a lesser degree in 1994. For all other years, claims were quite modest. It makes no sense to assume that the agency's experience for 2001-2002 reflects its future. This has never been the case. The Subcommittee should seek information on the experience over time of actual claims presented to the PBGC.

4) CONSISTENT & TRANSPARENT MECHANISMS FOR "PROBABLE" AND "POSSIBLE" CLAIMS. The agency should develop more consistent and transparent mechanisms for including "probable" terminations in its surplus/deficit calculations as well as for announcing "possible terminations." The PBGC reports three kinds of claims – actual claims that have been presented to the corporation; "probable" claims that it expects to receive in the near future; and "possible" claims that it might receive over the next several years. The differences are substantial and important. For example, for FY 2002, although the PBGC reported an $11.3 billion swing in is surplus/deficit position,

$6.3 billion, or over half, is attributable to "probable" claims that did not, in fact, occur during FY 2002. Put another way, gross liabilities from probable terminations can be 20% to 30% of PBGC's total liabilities. The corporation's 2002 report (at page 40) indicates that it eventually trusteed 78% of plans reported as probable terminations between 1987 and 2001. This means it did not incur claims for 20% of probables during that time.

The criteria for the PBGC "probables' is not apparent. We question whether it is appropriate for the PBGC to report claims that are not yet incurred using an undisclosed basis. We believe the PBGC should publicly state its criteria and that the Subcommittee should seek additional information in this area. In this regard, we note that the PBGC's inspector general stated "PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable plan terminations." (FY 2002 report, at page 48).

The mechanism for producing "possible" claims also is not a transparent one. The PBGC's 2002 report (at page 41) reports $35 billion of additional liability from terminations that might occur sometime in the future, a number bumped up to $80 billion in the PBGC's September 4 testimony.

There are both public information and policy concerns with these reports. Without clear criteria regarding how these numbers are produced and what they mean, it is far too easy for the public to assume that all $80 billion in new claims will occur and occur soon – just added onto the currently projected deficit. Indeed that is exactly what occurred in the next-day press reports. It does neither the PBGC nor the defined benefit system good to highlight large, easily misunderstood, and ill-defined numbers in public statements.

On a policy level, the data used to produce these numbers appears to be taken from the trough of the recent downturn, not reflecting recent upticks. In addition, it is unclear the mechanism by which these numbers are produced and whether these figures were subject to a reality adjustment. In other words, if at a particular point in time there is a net unfunded liability of $80 billion in companies with junk bond status, it does not mean that the corporation is likely to receive claims for all of these amounts. Were considerations such as this taken into account? It is not clear.

While we agree and believe that the PBGC should have some way of reporting reasonably expected claims, it appears that under the current undisclosed system there is considerable leeway in determining what year in which to include those expected claims as well as the criteria by which to select claims.

The Subcommittee should work with the PBGC and other experts to develop a more consistent method for the PBGC to provide information regarding probable terminations that have not yet occurred and that, historically, did not occur in 20% of the cases as well as a range of possible future scenarios.

What about PBGC proposals to cut off benefit increases?

The PBGC may face spikes in liabilities because of mis-matches between current law funding and guarantee rules. For example, the corporation has terminated plans in order to avoid being liable for unfunded shut-down benefits. Another approach may prove more satisfactory for both participants and the PBGC.

Other factors may also cause spikes in the corporation's liability in a terminating plan. We believe it is appropriate to work together to get a better understanding of such circumstances and to formulate rational policies to deal with them. For example, current law forbids enactment of a benefit increase in a plan less than 60% funded unless money or security is provided to restore the plan to a funded level of at least 60%. The PBGC has proposed additional such measures. Such measures should be evaluated against the following criteria: (1) The proposal should protect participants rather than merely shield the PBGC from additional liability. (2) The proposal should target actions that drive down a plan's funded status; it should not affect the normal operation of the plan. (3) The impact of the proposal should be predictable. A proposal to cease normal benefit accruals when a plan's funded status falls below an arbitrary level fails all three of these criteria.

Conclusion

The best security for the PBGC is a robust defined benefit system. While we have concerns about the PBGC's evaluation of its own condition as well as about some of its reform proposals, we are very supportive of the overall mission and management of the PBGC and would be pleased to work with it and the Subcommittee in evaluating and clarifying the issues we have discussed. In the meantime, it is critical to keep the primary focus today on responding to the very real and immediate crisis facing plan sponsors – replacement of the defunct 30-year bond.

ERISA'S FUNDING RULES AND WHAT SHOULD BE DONE ABOUT THEM

Introduction

The regulatory burden on defined benefit plans increased due to a seemingly endless stream of legislative restrictions enacted from 1982 through 1994, typically as part of deficit reduction measures enacted by Congress. Among other important matters, the amendments enacted between 1982 and 1994 severely curtailed the ability of companies to make tax deductible contributions to their pension plans, a fact that is important for today's discussion.

In addition, in 1987, and again in 1994, the government imposed an additional, back-up set of funding obligations on plans that were considered to be either severely or persistently underfunded on a current liability basis. A plan that becomes subject to the special current liability funding rules no longer enjoys the long-term perspective of ERISA's basic funding rules. Instead, it faces a sharp increase in cash contributions designed to reduce the plan's deficit by 20-30% per year. In determining the funded status of a plan for the purpose of these special funding rules, the government requires

use of a four-year weighted average of the 30-year Treasury bond rate and imposes a required mortality assumption.

Under these rules, plan sponsors today are caught in a squeeze play: In good times they are unable to advance fund their plans to prepare for cyclical economic downturns; and they must rapidly fund up when those downturns occur and when they can least afford it. The result is perverse and is a major factor in undermining the health and vitality of the retirement system.

Today's economic climate along with the perverse funding rules is further undercutting the attractiveness of defined benefit plans for employers. The current liability funding rules were never intended to apply to the majority of plans – but under the combined impact of reduced asset returns and lower interest rates, that is what is happening today.

Sadly, this flawed pension funding process has become a counterweight to U.S. fiscal policy. Every time the government lowers the rates to stimulate the economy, companies must rethink their future pension funding requirements. Funds that might previously have been earmarked for capital improvements and jobs growth, must now be set aside to provide for escalating pension funding requirements. In effect, the ability of companies to invest in the future of our economy is being held hostage by the very government actions intended to stimulate such growth.

Although the evidence is anecdotal, an increasing number of employers facing unrealistic cash calls under the pension funding rules are today freezing their plans for either new or current participants. Employers who are still maintaining their plans are not extending them to employees acquired during a business transaction.

The 30-year Treasury bond

When, in the late 1990's, the federal government began to buy back outstanding 30-year Treasury bonds from the open market, supply and demand factors forced the spread between a corporate rate and the 30-year Treasury rate required for pension funding calculations to widen. This situation worsened in 2001 when the U.S. Treasury ceased to issue new 30-year Treasury bonds. As a result, plan sponsors are left with a meaningless interest rate that artificially increases the calculation of pension liabilities and that fails to reflect any rational basis with which to regulate pension plan funding.

The inappropriateness of relying on the 30-year bond as a benchmark has been generally recognized since the late 1990's when the government began to buy back these bonds, causing their rate to drop substantially relative to historical levels and relative to other benchmarks. In late 2001, the bond was discontinued entirely. In early 2002, Congress recognized the problem by enacting a temporary higher rate that can be used by pension plans for 2002 and 2003. In August 2002, ERIC proposed a composite rate of high quality, long-term corporate bond indices as a permanent replacement for the 30-year rate. The framework of this proposal has been endorsed by the entire business community as well as the AFL-CIO, included in legislation introduced by Sen. Judd Gregg (S.1550) and Reps. Rob Portman and Ben Cardin (H.R.1776), approved by the

Ways and Means Committee for 2004-2006, and recommended by the Administration for use in 2004 and 2005. But all of this is for naught if Congress fails swiftly to bring this solution to the President's desk to be signed into law.

Prompt action to replace the defunct 30-year Treasury bond rate for purposes of regulating pension plans is critical to protect the retirement security of millions of American workers and to avoid undercutting the ability of many companies to fuel national economic recovery

The solution

There has been a general recognition that a high quality, long-term corporate bond rate provides an appropriate and reasonable measure of pension obligations.

ERIC urges you to recommend that the government replace the 30-year Treasury rate with a composite rate of high-quality, long-term corporate bond indices that would be selected through Treasury regulations. ERIC also proposes to

- Coordinate the new rate with related mortality assumptions;
- Phase in the new rate for lump sum calculations; and
- Reduce the frequency with which employers bounce in and out of the current liability funding and quarterly contribution requirements.

A composite corporate bond rate corresponds to the rationale Congress outlined when it established the current liability funding rules in 1987. It reflects the returns on an insurance company portfolio that funds group annuities. The proposed composite rate is higher than today's 30-year Treasury rate. But this is appropriate because the current use of the Treasury rate <u>overstates</u> the minimum funding needed to assure retirement security for plan participants.

Moreover, other possible replacements for the 30-year Treasury rate do not provide the combination of simplicity, transparency, relevance, immunity from manipulation, and availability provided by a composite corporate bond rate.

What happens if the 30-year Treasury rate is not promptly replaced?

Companies today are preparing to implement their 2004 budgets. If Congress fails to act, 2004 current liability calculations will be dictated by a maximum rate of 105% of the four-year weighted average of (the defunct) 30-year Treasury bonds. Projecting the July 2003 through the end of the year, this would mean that plans would be forced to calculate their current liabilities with a maximum interest rate of 5.47% compared to 6.83% under the ERIC proposal. If this were to occur–

- Current liability calculations would increase by 15% or more.

- Many additional companies, including companies with plans that are in fact well-funded, must assume they are subject to the special funding rules. Both they and those already subject to the rules will experience a spike in their contribution

requirements. This will unnecessarily divert money that otherwise would have been spent to build new plants, buy equipment, pay for research and development, and support jobs.

- Plans that become subject to the current liability funding rules also must notify employees of their underfunded status (even if the plan is not underfunded using reasonable measures), and must pay variable rate premiums to the PBGC. Business operations of these plan sponsors also come under increased scrutiny by the PBGC.

- Companies will suffer reduced credit rankings and diminished stock values.

There is no economic justification for these consequences. Thus, it is apparent that affected companies will find their support for defined benefit plans diminished. A strong financial incentive will be created to limit future liabilities. Where cash is in short supply, companies will have no option but to freeze their plans.

There is additional fall-out just from the uncertainty companies currently face. CEOs and CFOs need to know now whether they will be able over the next several years to purchase new plant and equipment, to invest in research and development, and to accomplish other vital business objectives.

Consequences of the funding squeeze, caused in part by the continued reliance on the 30-year Treasury rate, already are occurring. A recent survey by Deloitte & Touche indicated that more than four out of ten defined benefit plan sponsors are either making or are considering making fundamental changes to their defined benefit plans. About a quarter of those making or considering changes either already have or are inclined to freeze benefits in the plan.

Action on a replacement rate is needed now. Analysts already are steering investors away from companies with a cloudy contribution forecast. Planning for 2004 is already nearly complete. Delay means damage to plans and their participants, damage to companies, and damage to companies' ability to fuel economic recovery.

Why should a composite corporate bond rate be selected as the replacement for 30-year Treasury rates?

The current liability funding rules are designed to shore up funding in a plan that would have a serious shortfall if it were to terminate and need to purchase annuities to provide benefit payments. Thus, as the GAO reported recently, "the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices and not be subject to manipulation." (GAO-03-313)

Insurance companies portfolios mirror investments in long-term corporate debt. Therefore, a composite corporate bond rate will track changes in annuity purchase rates and will mirror the investments used to fund annuities.

ERIC'S composite rate is composed of high-quality, long-term corporate bond indices. High quality bonds (i.e., generally the top two quality levels) provide a conservative level of security for pension plan sponsors to defease their liabilities.

ERIC's composite rate indices also are comprised of bonds with average maturities of 25-30 years (implying durations of 10-12 years), which corresponds to the typical duration of pension plan liabilities.

When the 30-year Treasury bond rate was selected as a compromise for the new pension funding rules established in 1987, Treasury rates were closer to corporate bond rates than they are today. Moreover, mortality assumptions in use at the time were outdated, so having an interest rate that was overly conservative made sense.

The composite corporate bond rate in the ERIC proposal is based on indices that are

- published by major investment houses,
- based on disclosed methodology, and
- publicly available.

The composite rate is

- based on information familiar to plan actuaries;
- simple for plans to implement;
- transparent,
- strongly immune from manipulation, and
- not subject to swings caused by government decisions having nothing to do with pension funding.

What's wrong with selecting another government rate or a yield curve instead of a composite corporate bond rate?

The events of the last five years prove that it is fundamentally flawed to peg pension plan security to any government bond rate. The U.S. government must be free to exercise its legitimate fiscal and monetary policy without wreaking havoc on pension funding.

Any other government rate is going to suffer from the same weaknesses as the 30-year Treasury rate – any relation to annuity funding will be tangential or accidental. Indeed, as the GAO noted (GAO Report –GAO-03-313, p. 5), "Treasury rates' proximity to group annuity purchase rates might be adversely affected if investors' demand for risk-free securities increases, causing Treasury rates to decline relative to other long-term rates."

Government rates reflect the government's fiscal and monetary policy, not the rate of return on an insurance company's portfolio. Thus they are inherently irrelevant as a benchmark for pension funding.

The administration has proposed moving in three years to a corporate bond yield curve – an as yet unconstructed and undefined rate that would be based on projections of future cash flows from the pension plan and that would apply lower rates to more immediate cash flows and higher rates to payouts expected in later years. Corporate bond yield curves bring with them several drawbacks. For example:

- The current liability and its associated funding rules were enacted as two components of a political solution to the problem of habitual under funding of some pension plans. It is inappropriate and unfair to establish a fundamentally new concept for determining the current liability without concurrently addressing the associated funding rules. Indeed changing to a yield curve would require a total re-writing of those rules, which are highly reticulated.

- A yield curve may produce a more "precise" measure of a plan's liabilities, but may well fail to produce a more "accurate" measure. It is, in itself, based on many guestimates, predictions, and assumptions, and, as a spot measure, it ignores the long term nature of pension obligations.

- There has been little public discussion of a yield curve, a complicated proposal. Adequate consideration of a yield curve could not occur under the current time constraints. There are a number of highly technical issues involved in switching to a yield curve that have not been explored or addressed.

- Companies already unsure of their cash flow situation will be thrown into even greater confusion, to the detriment of their ability to participate productively in the economy.

- Since it would make no sense to average a yield curve over four years, an annual rate likely would be used. Unless some other "smoothing" mechanism is devised, this will substantially increase pension funding volatility.

- In addition to decreasing pension funding volatility, the current averaging mechanism gives plan sponsors the ability to estimate funding obligations well in advance of the year for which they are due. Basing contributions on an unknowable "spot rate" decreases the ability of sponsors to plan capital commitments.

- Introducing volatile, unpredictable cash flow requirements is a significant burden on plan sponsors. As a result, maintaining a defined benefit plan will become less and less economically feasible for more companies. It would be impossible to overestimate the negative impact of turning at this point in time to a pension funding system that increased the volatility and unpredictability of required pension contributions.

- A yield curve, combined with the current law deduction limits, could result in less ability for a plan sponsor to fund the plan while participants are younger because it would delay the ability to deduct maximum contributions to periods when the

workforce is more mature and declining, and when the company may face new or different economic pressures. It would, in effect, negate some of the good of the Grassley-Baucus amendment in EGTRRA, which phases out deduction limits that had a similar effect of delaying funding over the past decades.

- If a "precise" interest rate such as a yield curve is mandated, a precise mortality assumption also must be considered. Otherwise, industrial plans whose participants have shorter life spans will be required to excessively fund their pension plan. However, such use of such an assumption is likely to be controversial and will require additional discussion, as it will have different impacts on different plans.

- It is unclear how a yield curve would be applied for purposes of lump sum payments and interest on employee contributions, raising a host of additional issues and possibly resulting in windfalls for some participants and unfair loss of value for others.

- A yield curve is likely to be far less transparent than a composite index; it may be more vulnerable to manipulation; it will be more difficult for the government to police, and it certainly will be more complicated.

A yield curve may impose these drawbacks on the defined benefit system for no real long-term gain over the more simple and transparent approach of a composite corporate bond rate.

WHAT CAN THE SUBCOMMITTEE DO TO HELP?

The Subcommittee has important opportunities to improve the climate for defined benefit plans. It can --

- Convey to the Senate leadership the urgent need to replace the 30-year bond as a benchmark for pension regulation with a composite corporate bond rate.

- Urge or conduct an examination of the long term health of the defined benefit system.

- Ensure that appropriate steps are taken to provide a clearer picture of the long term health of the pension benefit guaranty system.

ERIC appreciates the opportunity to appear before the Subcommittee and will be pleased to respond to questions and engage in further discussions either at or after this hearing.

APPENDIX #1 – PLAIN ENGLISH EXPLANATION OF THE ERISA FUNDING RULES

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, ERISA and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan. These minimum required contributions are calculated using reasonable assumptions and are equal to the normal cost of the plan plus amounts necessary to amortize over specified periods unfunded past service liabilities, experience gains or losses, waived funding deficiencies, changes in actuarial assumptions, and certain other items. Most defined benefit plans are funded under these original ERISA rules, as modified over time.

A plan that is considered either significantly or persistently underfunded will be subject to an additional set of funding rules. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises in the future. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan, accelerating the pace of pension funding. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994, and are the focus of our discussion today.

The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is within a range of rates based upon the four-year weighted average of 30-year Treasury bonds. As amended in 1994, the permissible range is no lower than 90% of the 30-year bond average and no higher than 105% of the 30-year bond average. For 2002 and 2003 only, a plan may use a rate of up to 120% of the 30-year bond average. Congress enacted this short term-higher range last March (P.L. 107-147) in recognition of the fact that, as a result of the rise of budget surpluses followed by the decision of the Treasury to cease issuing 30-year bonds, the 30-year bond rate had dropped to levels that produced highly inaccurate and inflated calculations of pension liability.

The current liability rules come into play if, using these mandated assumptions, a plan is either considered significantly or persistently underfunded -- that is, if plan assets are less than 80% of current liabilities or if plan assets are less than 90% of current liabilities for two of the last three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

Current liability is also calculated to determine whether a plan sponsor will pay a $19 per participant flat rate premium tax to the Pension Benefit Guaranty Corporation, or whether the sponsor must, in addition, pay a variable rate premium tax based on the plan's unfunded vested benefit liability.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.

APPENDIX #2 – INFORMATION ABOUT LUMP SUMS

It is important that the lump sum discount rate reflect the plan's discount rate. Any disconnect between the lump sum rate and the funding rate will cause plan distributions to either exceed or fall short of estimates used in the plan.

Plan sponsors and Congress never intended lump sum payments to unilaterally siphon off a disproportionate share of pension assets. In fact, during the late 1980s and early 1990s, when interest rates were in excess of 7%, the PBGC discussed whether lump sums were inappropriately threatening pension plan security.

Today's low rate also presents participants deciding between a lump sum distribution and an annuity, a choice that is overwhelmingly weighted toward the lump sum. This is in direct contravention of long-established policy that the choice should be economically neutral. As election of lump sums increases, fewer joint and survivor benefits are selected, adversely affecting long-term participant security. In addition, the plan's funding level is adversely impacted, compounding the very problem we are trying to solve. Sponsors cannot eliminate lump sum provisions for already accrued benefits, thus precluding plan sponsor correction of this problem.

- Lump sums paid under a defunct Treasury rate are, in fact, windfall benefits that have damaging side effects for long term retirement policy, for the company sponsoring the plan, and for the PBGC.

- Elderly widows and widowers and others who outlive their assets and have no retirement income stream other than Social Security constitute one of the most vulnerable pockets of poverty today. The current lump sum structure will increase the number of spouses and others left adrift in the future if that lump sum is dissipated.

- Actuarial estimates indicate that a lump sum benefit under the current inappropriate discount rate increases the cost of the benefit to the plan by 17-40%. Many plans cannot absorb these costs and have been freezing or curtailing benefits. Thus, while some current retirees receive a windfall based on an anomaly in the government debt structure, future retirees will receive reduced benefits overall.

- Finally, Internal Revenue Code section 417(e) not only dictates the minimum lump sum rate, but also the rate that regulations encourage companies to use as the interest credit rate in cash balance plans. Thus, maintaining an artificially low lump sum rate for some current retirees means that millions of participants in cash balance plans are losing benefits compared to what they would be earning if the rate were rational.

ERIC proposes that the new interest rate be phased in over a three-year period. The three-year phase-in will align the new and old rates over time while ensuring that the shift

from a defunct 30-year Treasury rate to the composite rate will not have abrupt effects on participants at or very near retirement.

A recent study by the American Academy of Actuaries shows that participants continuing to work will see their lump sum dollar amounts continue to grow during a phase in to a new corporate rate. The effect of the employee's additional accruals and smaller pre-65 benefit reduction outweigh the phase in of the higher rate.

Section 705 of H.R.1776 by Reps. Portman and Cardin provides for a seven-year phase in of the bill's new corporate rate for lump sum calculations. This approach has proved acceptable to both the business community and the AFL-CIO [see May 9, 2003, letter from AFL-CIO to Ways and Means Committee Chairman Bill Thomas].

Historically, the lump sum discount rates have averaged about 7%. The July 2003 mandated rate is 4.93%. Under the ERIC proposal, if current rates remained in effect without change, the lump sum rate would gradually increase to a level of about 5.79% over a three-year period – still short of historical averages. The phase-in is designed to roughly approximate normal fluctuations of interest rates in a given year. Thus, the changes would be within the margins of change that already occur on a year-to-year basis. In addition, in the second and third years, lump sums of many employees would increase from estimates made today because additional years of age and service would be included in the calculation.

APPENDIX #3 – INFORMATION ABOUT MORTALITY ASSUMPTIONS

Under current law, Treasury is required periodically (and at least every five years) to review the mortality table required for current liability funding calculations and to update the table as appropriate to reflect the actual experience of pension plans (including permitting plan-specific adjustment factors such as employment classification, lifetime income, and other relevant demographic factors) and projected trends in such experience. An update in the required table is overdue.

ERIC recommends that the use of the RP 2000 Combined Mortality Table, produced by the Society of Actuaries based on a large study of pension plan experience, be required for funding and variable rate premium purposes at the time the composite rate becomes effective. Use of the new table will have the effect of increasing current liability calculations for most plans, partially offsetting the effects of adopting the composite corporate bond replacement for the 30-year Treasury bond.

ERIC proposes no changes for mortality assumptions for lump-sum distributions, since they already are being updated under a separate provision of law.