ERIC

THE ERISA INDUSTRY COMMITTEE

Representing the Employee Benefits Interests of America's Largest Employers

1400 L Street NW Suite 350 Washington DC 20005 Phone: (202) 789-1400 Fax: (202) 789-1120

POLICY STATEMENT
REFORMING THE GOVERNANCE OF DEFINED BENEFIT PENSION PLANS
Prepared by The ERISA Industry Committee
at the Request of the Administration
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ERIC welcomes this opportunity to respond to the Administration's July 24, 2003 request for recommendations for reforms that would be appropriate and necessary for the funding and other related rules governing defined benefit pension plans. While comprehensive reforms require far more than eight weeks to formulate and examine, we set forth below principles that should govern this longer-term process.

Defined benefit pension plans voluntarily provided by employers for their employees 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 typically automatic; in most plans employees do not have to make an election or reduce their wages in order to accumulate retirement savings.

- Unlike defined contribution plans, defined benefit plans require the employer to shoulder the investment risk; and, for most participants, benefit amounts are fully guaranteed by the Pension Benefit Guaranty Corporation (PBGC).

- Benefits under a defined benefit plan can be adjusted to retain their full economic value in the face of 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. Many plans also provide ad hoc cost of living increases for retirees.

- Plans must offer an annuity payout option that ensures that annuitants do not outlive their savings.

- Plans must offer benefit options to survivors, addressing one of the most critical retirement security issues facing retirees and their families.

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

- The more than $1.6 trillion held in private sector defined benefit pension trusts is an important source of long-term investment in the nation's economy.

Whether defined benefit plans will continue to be available on a wide-spread basis in the future, however, is an open question. Defined benefit plans today are under unprecedented pressures: volatile and often oppressive 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 that want to provide a retirement plan for their employees from adopting or retaining a defined benefit plan.

As a result, over the past several decades the number of participants in defined benefit plans has remained relatively constant while the workforce has grown, and participant demographics have shifted significantly from active to retired employees. 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. Today, an unprecedented number of companies are freezing their plans – closing them to new entrants or ceasing future accruals for current participants.

What the government does in the coming weeks and months will tip the balance one way or the other – toward a retirement system that continues to offer employers and individuals realistic options under both defined benefit and defined contribution plan designs 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 income for future retirees.

In short, the health and vitality of the nation's defined benefit retirement plans and accordingly the retirement security of millions of American workers is at stake in the current debate and analysis over funding and other reforms. Consider the following:

- Beginning in the early 1980's, layer upon layer of burdensome regulation, often overlapping and sometimes contradictory, was 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 has only started.

- Government regulation prevents a company from placing extra funds in its plan during favorable economic times and imposes harsh funding requirements during economic downturns. It over-relies on mandated point-in-time measures of liability that impose volatile funding requirements that are unworkable for businesses in a competitive and constantly changing 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.

- Government restrictions on benefits that could be earned and paid under a defined benefit plan imposed during the 1980s primarily for federal revenue purposes undercut ERISA's vision of a single plan for both bosses and workers by reducing the impact of qualified plans in the retirement planning of small and medium business owners as well as senior managers of large businesses.

- The United States is lurching toward the retirement of the largest demographic group in its history with no meaningful, coordinated and coherent 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 our nation's citizens.

<u>If defined benefit pension 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 in the retirement system.</u>

The legislative and regulatory environment governing defined benefit plans should be transformed from one that is incomprehensible, volatile, and self-defeating to one that is understandable, predictable, and effective. The current forbidding and inhospitable environment – which discourages employers from establishing and preserving defined benefit plans – should be reformed to encourage the formation and continuation of defined benefit plans.

Accordingly, ERIC proposes that any proposals for reform of current laws 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. Attempts to couple this action with other actions that are more long-term in nature should cease as such actions are counter-productive, confusing, and ill-timed. Plan sponsors are making decisions today regarding their cash flow for the first quarter of 2004 and beyond. Money unnecessarily put in a pension plan under today's faulty 30-year Treasury bond standard cannot be recouped later by the company. Failure to take immediate action to replace the 30-year bond with an easily-implemented composite bond rate not only jeopardizes the continuation of many plans, it also unnecessarily robs the economy of critical financial resources needed for jobs and company expansion.

(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, decisive action 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. It can do this through public statements that encourage employers to consider establishing plans for their employees, by providing clear information to employers on how to establish and maintain plans, and by formulating laws and regulations that provide a clear, flexible, and responsive framework. Defined benefit plans have suffered for years from a regulatory framework that on the one hand is overwhelmingly detailed and complex and on the other hand fails to provide the necessary structure or support for new plan designs such as hybrid plans.

(3) COORDINATION. ERISA is a reticulated statute. It is critically important that reforms not be enacted in a piecemeal basis. For example, proposals to change the structure of liability calculations to incorporate duration-adjusted discount rates have ramifications for plans, plan sponsors, and participants as well as equity and bond markets that have not been fully explored and that are poorly understood.

Reforms should be considered over time, based on comprehensive analysis, and with concern to understand the behavioral reactions that will occur among major stakeholders as well as with input from plan sponsors and participants. For example, onerous or volatile funding rules may reduce the attractiveness of a company to investors and trigger shareholder pressure to freeze or terminate the pension plan.

(4) LONG TERM COMMITMENT. Pensions are a long-term commitment. They are both funded and disbursed over decades. Short term, or spot measures of pension liability and funding requirements based on such measures inhibit business planning and make sponsoring a defined benefit plan less desirable because the cash call on the company can vary greatly from year to year. In this regard, ERIC recommends that any fundamental revision of the funding rules, especially the current liability funding rules, that might be considered in the future recognize that plan funding is appropriately evaluated over a long period and not on a spot basis. Moreover, while spot measures 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 meaningful measure of the plan's ability to meet its obligations over time. Any reforms should have as key objectives reducing the volatility of current law funding requirements, requiring only necessary funding and not forcing overfunding, and not forcing sponsors to alter long term investments in order to hedge against volatile funding requirements.

In this regard, we note that it makes no sense to describe the funded status of an ongoing plan in terms of its "termination liability." The information is misleading and often unhelpful. 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.

One of the primary aspects of a defined benefit plan that makes it attractive to employees and employers is its stability. Employees can count on the fact that all benefits they have earned to date will not be reduced by amendment or investment experience. At least in the past, employers could plan how to meet their pension obligations well into the future. Future reforms should seek to restore greater predictability for plan sponsors.

(5) CHANGING WORKFORCE. The U.S. workforce is changing. As employment shifts away from some industries and into others, some plans now have more retirees than active participants. It is a tribute to ERISA that most plans enter this mature phase of their existence with sufficient funds to continue to pay benefits to their participants. Even in plans with a preponderance of retirees, benefit payout typically is a long-term commitment – over ten to twenty years and longer. Thus proposals to impose different measures of liability on plans with a preponderance of retirees may unnecessarily impose additional and unnecessary burdens on those plans. No such changes should be enacted without careful public consideration of their impact and without a more in-depth public discussion of the causes of underfunding in all plans. Although the recently proposed yield curve concept might have some theoretical attraction, it interjects a potentially unrealistic and unnecessary element of false precision into the concept of pension funding and should be more thoroughly vetted before it is pursued any further.

In addition, changing career patterns, together with many employees' expectations that they will not remain with one employer for a period long enough to earn a meaningful benefit, has made the traditional defined benefit plan less attractive as a tool to recruit and retain needed employees in some industries. The government must work effectively with plan sponsors to establish a stable regulatory structure for existing and future plan designs that more effectively meet the needs of these workers and plan sponsors.

(6) DISCLOSURE. Disclosure rules should be considered separately from funding requirements. Disclosure should provide the employer, participants, the investment community, and the government relevant, helpful, and timely information concerning the long-term viability of the company's pension plan. Multiple different present value measures already are required with respect to pension plan benefits. The Administration proposals to add additional disclosure requirements on top of current requirements follow an ineffective piecemeal approach that will only add burdens on plan sponsors and create additional confusion in an area already suffering from lack of clarity. Instead, if disclosure is to be addressed, the current disorganized framework should be addressed in a coordinated and systematic fashion that results in requiring only simple, meaningful, and helpful disclosures that are appropriate for each interested audience.

In addition, the recent Administration disclosure proposals, which are based on extreme and unrealistic standards, appear 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 sponsor 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) MAJOR OVERHAUL UNNECESSARY. 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 increase and speed up the flow of cash to severely and persistently underfunded plans. These rules have improved the overall funded status of plans. Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform. It does not. Recent conditions of market downturn and low interest rates should be expected to produce temporary funding deficiencies that will, no doubt, self correct as conditions improve. We have, in fact, seen such corrections over the past few months. Some broad modifications to current rules could be considered over time to increase their effectiveness without impairing the attractiveness of defined benefit plans to employers.

(8) FLEXIBILITY. Current law disincentives to funding should be removed. Current law restricts deductions for contributions and tightly controls the timing of contributions. It also imposes excise taxes if a company contributes additional amounts so as to create a plan surplus, which may be a prudent practice during good economic times. These restrictions undermine the security of participants and make the defined benefit plan a less attractive option for the employer. Future rules should provide additional flexibility regarding the ability of an employer to fund the pension plan whenever the company has extra cash, should permit the full deductibility of contributions made, and should support innovations in plan design.

(9) THE PBGC. The PBGC should be operated and maintained on a sound financial basis. With more than $30 billion in current assets and approximately $800 million in annual premium income, the corporation is well able to pay benefits for the foreseeable future. Assumption of additional liabilities does not change this basic fact because the PBGC also receives the assets of a plan it trustees in the near term but (since it does not pay lump sum benefits) will pay out benefits only over decades. Unfortunately, information typically provided by the PBGC, such as a spot-rate based surplus or deficit, fails to tell either the government or premium payers whether the agency faces either near or long term solvency problems.

More informative measures of the PBGC's solvency should be developed and publicized. For example, in presenting its financials, the PBGC should place greater emphasis on its long-term ability to pay benefits as well as on average claims over time; it should use a more realistic discount rate in calculating its liabilities consistent with long-term return expectations; and it should develop a transparent and consistent mechanism for reporting "probable" and "possible" terminations.

The PBGC may face spikes in liabilities because of mis-matches between current law funding and guarantee rules. For example, the PBGC has terminated plans in order to avoid being liable for unfunded shut-down benefits, a procedure that is difficult for the PBGC and that results in participants losing valued benefits. Another approach may prove more satisfactory for both participants and the PBGC and should be part of any reform analysis.

Other factors may also cause spikes in the PBGC's liability for a terminating plan. 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 counter 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.

(10) BENEFIT GUARANTEES. After more than 25 years experience with the current guaranty system, it would be appropriate to reconsider what guarantees should apply to plans that are terminated with insufficient funds. For example: What benefits should be insured? What level of guarantee is appropriate? What types of contingencies might apply to guarantees? Should different types of plans trigger differently designed guarantees?