THE ERISA INDUSTRY COMMITTEE

1400 L Street NW, Suite 350, Washington DC 20005 (202) 789-1400 fax: (202) 789-1120 www.eric.org

ADVOCATING THE BENEFIT AND COMPENSATION INTERESTS OF AMERICA'S MAJOR EMPLOYERS

CONSENSUS PROPOSALS FOR PENSION FUNDING, PBGC REFORM, AND HYBRID PENSION PLANS

MAY 2005

EXECUTIVE SUMMARY

THE CURRENT DEBATE

Current policy discussions regarding defined benefit pension plans typically focus on perceived financial vulnerabilities of the Pension Benefit Guaranty Corporation (PBGC – the agency that guarantees pension payments from failed plans), on allegations that defined benefit pension plans are today seriously underfunded, and on the declining number of plans being offered.

- Private sector defined benefit pension plans pay approximately $110-120 billion in benefits to retirees every year. By comparison, the PBGC in 2004 paid just over $3 billion in benefits, or 2.6% as much. Over 44 million Americans receive benefits from defined benefit plans or will receive benefits in the future. By comparison, the PBGC's present and future benefit population was 1.06 million at the end of 2004, or 2.4% as large a group. Moreover, in 2004, the PBGC received approximately $1.5 billion in premium payments and earned $3.2 billion by investing its assets. The PBGC does not face a liquidity crisis, and it is clear that the critical focus of the retirement security debate is maintaining a vibrant, attractive, and healthy defined benefit pension system.
- The funded status of defined benefit plans cannot be gauged on a short-term basis. Assets in private sector defined benefit plans totaled $2.056 trillion at the end of 1999, dropped to $1.531 trillion at the end of 2002, but climbed back to$1.8 trillion by the end of 2004. Moreover, the interest rate for calculating current liabilities, which was 7.17% for 1998, is 6.1% for 2005. If interest rates rise by 100 basis points, current liability calculations will decrease by $200 billion.
- Defined benefit plans are a very cost effective way to provide real retirement income to workers. Because both the risk of investment loss and longevity risk are pooled, larger benefits can be provided for less cost. Large income means greater retirement security. Thus, employers and employees both will continue to seek these plans. By clarifying the status of hybrid plans and by providing a sound regulatory framework that encourages employers to establish and continue plans, recent declines in the numbers of defined benefit plans can be brought to a halt and perhaps reversed.

From its beginning in 1975 through the end of 2003, the PBGC has assumed responsibility for 3,277 plans. Over that same period, 164,000 plans – or 50 times as many – terminated fully funded and without imposing any obligation on the PBGC. The vast majority of plans are not a threat to the PBGC – but harsh and volatile rules are a threat to the vast majority of plans and to the businesses that sponsor them. Unfortunately, many aspects of the Administration's proposals, if enacted, would hinder the continuation and establishment of pension plans.

ERIC PROPOSALS

Some issues that have come to the surface in recent years deserve serious consideration and positive action. To address these issues, ERIC urges the following actions.

Regarding contributions that plan sponsors are required to make to their pension plans:

1. Enact a permanent interest rate to calculate current liabilities.
2. Retain the long-term ERISA funding rules, but reduce the amortization period for plan amendments that increase benefits from 30 years to 10 years.
3. Retain present law averaging of current liability interest rates and plan assets.
4. Enact the present-law composite corporate bond rate as the permanent interest rate for the short-term (current liability) funding rules.
5. Include lump sums in the current liability calculation.
6. Apply the permanent composite corporate bond interest rate to calculate the minimum lump sum amount, after an appropriate phase-in.
7. Reject the Administration's proposal to provide different rules based on a company's credit rating.
8. Accelerate funding any time the plan is less than 90% funded.
9. Retain credit balances, with modifications.
10. If plan-specific interest rates are mandated, also allow plan-specific mortality assumptions.

Regarding contributions plan sponsors are permitted to make to their plans:

1. Enact the modifications to defined benefit plan funding and benefit limits included in EGTRRA on a permanent basis.
2. Allow deductible contributions to be made up to 130% of current liability, and, in addition, allow deductible funding above 130% of current liability for future salary and benefit increases.
3. Repeal the 25% of compensation limit for Title IV plans.
4. Eliminate the 10% excise tax on nondeductible contributions.
5. Allow pension plans to fund savings plan contributions on behalf of the pension plan's participants.

Regarding the solvency of the Pension Benefit Guaranty Corporation:

1. Reject the Administration's proposed increases in the PBGC premiums.
2. Treat shut-down benefits as a plan amendment for funding and guarantee purposes as of the date they are triggered. Also, apply to shut-down benefits the restrictions under present law and proposed below that apply to payment of lump sums.
3. Freeze the benefit the PBGC will guarantee at the time of bankruptcy.
4. Prohibit amendments that increase benefits if the plan is less than 70% funded and has been less than 100% funded for more than a year.
5. If the plan sponsor is in bankruptcy, limit the percentage of any lump sum.
6. Retain present law prohibitions on benefit amendments in bankruptcy as well as on lump sums and other accelerated forms of benefit payments in the case of a plan with a liquidity shortfall.
7. Encourage employees to opt for annuity payout forms by (a) conforming the interest rate applicable to lump sums to the corporate rate used for funding; and (b) providing tax incentives for annuity payments from qualified plans.

8. Provide for greater flexibility in developing solutions for specific industries that will increase the likelihood that companies will be able to restructure their enterprise and avoid distress terminations of their pension plans.

Regarding disclosure:

1. Provide participants annually with a statement of the plan's funded status based on timely information currently available – such as information on plans compiled for SFAS 87 disclosure.
2. Replace the SAR with the report described above.

Regarding hybrid defined benefit pension plans:

1. Confirm, both retroactively and prospectively, that plans that recognize the time value of money, such as cash balance, pension equity, contributory defined benefit, indexed career pay, and variable annuity plans, are not age discriminatory.
2. Provide that a conversion of a traditional plan to a hybrid plan would comply with the age discrimination requirements if (a) neither the old benefit formula nor the new benefit formula discriminated on its face on the basis of age, and (b) the conversion did not violate the anti-cutback rule in effect on the date of the conversion.
3. Eliminate whipsaw both prospectively and retroactively (excluding cases that have been finally resolved).
4. Provide that if a plan provides participants with the benefit produced by two or more alternative formulas, the plan will comply with the anti-backloading rules (on both a prospective and retroactive basis) if each of the formulas, tested separately, complies with those rules.
5. Clarify, both prospectively and retroactively, that if a plan provides for an offset for benefits provided by another plan, the plan will comply with the anti-backloading rules if the gross benefit formula complies with these rules.
6. Direct the Treasury not to revisit the nondiscrimination testing issue raised by the proposed and 401(a)(4) regulations that Treasury has withdrawn.
7. Direct the Treasury to begin issuing, by a date certain, determination letters to plans that have been converted from traditional designs to hybrid designs.

CONCLUSION

As the PBGC has stated, the agency faces potential long-term issues but does not face a liquidity crisis. It has on hand sufficient assets to pay trusteed benefits for many years into the future. Moreover, when it trustees a plan, its asset base grows. Unfortunately, PBGC is locking in current deficit projections by transferring its investments to bonds and fixed income, and the Administration is proposing that the entire projected PBGC deficit be paid off by plan sponsors over the next ten years or less.

This self-defeating approach to PBGC security is compounded by the Administration's proposals to impose volatile and overly expensive funding requirements on all plans and to impose an expansive definition of liability as well as harsh benefit and guarantee restrictions on the plans of any company that drops below investment grade. At a minimum, the Administration's proposals are a strong incentive for employers not to sponsor defined benefit plans in the future, further weakening, not strengthening, the PBGC's future prospects. More importantly, the Administration's proposal will weaken the retirement security of future retirees just as the baby boom is reaching critical ages. If the proposals are enacted, millions of workers will enter retirement with less money.

Actions such as those recommended by ERIC should be taken to improve the function and security of defined benefit plans while also protecting the PBGC against unreasonable losses.