



TESTIMONY OF  
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ON BEHALF OF

AMERICAN BENEFITS COUNCIL  
ERISA INDUSTRY COMMITTEE  
AND  
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE  
HEALTH, EMPLOYMENT, LABOR AND PENSIONS SUBCOMMITTEE OF THE

U.S. HOUSE OF REPRESENTATIVES  
EDUCATION AND LABOR COMMITTEE

IN THE HEARING ENTITLED

"RETIREMENT SECURITY: STRENGTHENING PENSION PROTECTIONS"

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My name is Scott Macey and I am Senior Vice President and Director of Government Affairs for Aon Consulting, Inc. I have advised companies on retirement plan issues for over 30 years. Moreover, during that period, I have been an active participant in the public policy discussions affecting pension plans, both directly on behalf of our clients and through the trade associations in which Aon participates.

I am testifying today on behalf of the American Benefits Council (the "Council"), ERISA Industry Committee (ERIC) and National Association of Manufacturers (NAM). The Council's members are primarily major U.S. employers that provide employee benefits to active and retired workers and that do business in most if not all states. The Council's membership also includes organizations that provide services to employers of all sizes regarding their employee benefit programs. Collectively, the Council's members either directly sponsor or provide services to retirement and health benefit plans covering more than 100 million Americans. ERIC is committed to the advancement of employee retirement, health, and compensation plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage and other benchmark economic security benefits directly to tens of millions of active and retired workers and their families. ERIC has a strong interest in economic policy affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in America's economy. NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The vast majority of NAM member companies provide pension benefits for their employers.

The Council, ERIC and NAM very much appreciate the opportunity to testify with respect to the critical retirement security issues facing our country. We acknowledge the tremendous amount of work that led to the enactment of the Pension Protection Act of 2006 (the "PPA"). The PPA reflected a recognition of the importance of retirement security issues and included many reforms that we supported. It is a comprehensive legislative reform of the retirement system affecting almost every aspect of the private employer-sponsored retirement system.

In legislation as extensive as the PPA, it is inevitable that some provisions need to be modified to achieve Congress' original intent. Beyond the technical correction process, there are issues where modifications are needed to avoid unintended consequences. We applaud you, Chairman Andrews and Ranking Member Kline, for holding this hearing to identify those issues and we hope we can be of assistance in your efforts in this respect.

### **Precarious State of the Defined Benefit Plan System.**

The defined benefit system has been one of the key bulwarks of retirement security for working Americans for several generations. However, as we all know, the defined benefit plan system has been in significant decline in recent years. Employers

are increasingly exiting the system.<sup>1</sup> The total number of PBGC-insured defined benefit plans has decreased from a high of more than 112,000 in 1985 to fewer than 31,000 in 2005.<sup>2</sup> This downward trend is even more sobering if you look solely at the past several years. Not taking into account pension plan freezes (which are also on the rise but not officially tracked by the government),<sup>3</sup> the PBGC reported that the number of defined benefit plans it insures has decreased by 7,000 (or 20%) in just the last five years.<sup>4</sup>

And today is perhaps the most problematic time for defined benefit plan sponsors. With other companies exiting the system in increasing numbers, remaining defined benefit plan sponsors are asking themselves everyday whether to continue to provide defined benefit plan benefits to their employees. Competitive pressures and the critical need to make long-term business plans are undermining employers' ability to remain committed to the system. And we cannot overestimate the threat to the system posed by what the Financial Accounting Standards Board ("FASB") is contemplating in "Phase II" of its reexamination of the accounting standards applicable to pension plans. FASB's Phase II could introduce tremendous volatility to corporate income statements, leading to a whole new group of companies freezing or terminating their plans.

For the above reasons, both the Council, ERIC and NAM are constantly hearing from their members about possible plan freezes and terminations. In this context, it is critical that public policy achieve an appropriate balance that encourages employers to remain in the system. It is in this spirit that we offer the following thoughts on key modifications of the PPA.

### **Effective Date of the PPA Funding Provisions.**

We first want to discuss the effective date of the PPA funding provisions. The funding reforms will have an enormous effect; the reforms will change the funding obligations of major employers by hundreds of millions of dollars, and in some cases billions. For this reason, Congress devoted a huge amount of time to fine-tuning those rules, and Congress further provided a delayed effective date until 2008, so that

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<sup>1</sup> In 2004, the Council released a white paper discussing in detail the multiple threats to the defined benefit system. See American Benefits Council, White Paper, *Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System* (May 2004), available at [http://www.americanbenefitscouncil.org/documents/definedbenefits\\_paper.pdf](http://www.americanbenefitscouncil.org/documents/definedbenefits_paper.pdf).

<sup>2</sup> Pension Benefit Guaranty Corp., *Pension Insurance Data Book 2005*, at 2 & 8 (2006), available at <http://www.pb.gc.gov/docs/2005databook.pdf>.

<sup>3</sup> A plan freeze typically means closing the plan to new hires and/or ceasing future accruals for current participants.

<sup>4</sup> PBGC *Pension Insurance Data Book 2005*, *supra* note 5, at 58.

companies would have the ability to plan ahead as to how to address their new obligations.

The problem we are facing is simply stated. In the context of corporate planning, the 2008 effective date is drawing very close and we have not yet seen proposed regulations regarding how the funding rules will work. If the proposed regulations were issued today, the final rules could not be issued until late 2007. More than likely, final rules may not be issued in 2007 and sponsors will thus have to rely on temporary guidance. And, even if final guidance were issued, there is likely to be insufficient time to react to it prior to its becoming operative. Moreover, given the enormous task confronting the Treasury, it appears that any regulations issued on the first round will not be complete, leaving employers to guess at – and be at risk for – actions they need to take to ultimately be in compliance with regulations once the “holes” in the regulations are “filled” at a later date. Thus, for reasons discussed below, we urge a reasonable delay in the implementation of the new funding provisions.

Before discussing this issue further, we want to make it very clear that we do not fault the Administration in any way for the absence of funding guidance. The PPA created enormous pressure on the Treasury Department and the Department of Labor. Both agencies have risen to the occasion by devoting tremendous resources to the PPA issues. They have also reached out to the various stakeholders to identify priority issues and they have issued critical guidance to address many of the priorities. I can personally say that I have been extremely impressed and grateful for the dedication, professionalism and responsiveness of agency officials working on PPA guidance. Very simply, however, there have been too many priority issues. Congress could not have foreseen this and the agencies could not have done more to address the problem. That is why we are here today to discuss this unanticipated development.

As I noted, the lack of guidance regarding the funding rules is a huge problem. Let me illustrate why I say that. Small differences in a few of the key rules - - the yield curve, the mortality table (including the rules governing the ability of a plan to use its own substitute mortality table), and the asset smoothing rules, for example -- could create enormous differences in liability and, thus, funding requirements. For instance, assume that a plan is projected to have as of January 1, 2008, \$18.4 billion of assets and an estimated liability of \$20 billion. If those measurements are correct, such a plan would be 92% funded and would have no funding shortfall to amortize in 2008, based on the PPA's transition rule (which is discussed further below). Assume, however, that in November of 2007, the Treasury Department issues final guidance on the yield curve, the mortality tables, and the asset smoothing rules. Assume further that under the guidance, the plan assets are valued at \$17.3 billion and the plan's liability is valued at \$20.5 billion, very modest changes that are distinctly possible as a result of regulatory guidance. That plan would have a funding shortfall of \$3.2 billion to begin amortizing in 2008 (only partially attributable to the problem with the PPA's transition rule),

triggering a 2008 funding obligation of over \$500 million plus the cost of any 2008 benefit accruals.

Businesses cannot absorb that type of sudden increase in costs. In the current defined benefit plan environment, as described above, the reaction to that type of surprise would be swift and decisive in many cases: all new benefit accruals would likely cease and the plan would be frozen in order to control costs.

It was never Congress' intent to surprise companies with \$500 million of new costs a couple of months before the costs begin to apply. That is why the effective date of the funding rules was 2008. But Congress left much of the details regarding the funding rules to the Treasury and, in combination with all the other PPA guidance priorities, probably not sufficient time to develop all the rules, especially in light of the necessary input and comment from the public. In light of the current lack of guidance with respect to the PPA funding rules, it is critical that the effective date of the funding rules be delayed until 2009.

**Public comment is critical.** In this regard, it is very important that the effective date problem not be addressed by the issuance of funding rules that have not been the subject of public comment. The funding rules have enormous public significance and accordingly would benefit greatly from public comment. The give and take between the government and the public is one of the hallmarks of our system and has led to far better rules and far more respect for the system. It is critical that this valuable part of our governmental process remain intact: the funding rules should not go into effect until they have been the subject of public comment.

**Current state of plan funding.** One question that could be raised is: what is the cost of delaying the effective date? Could a delayed effective date let plans become more underfunded? Happily, the market has helped us a great deal in this respect. A recent study by a national consulting firm -- Milliman, Inc. -- examined the funded status of plans maintained by 100 very large U.S. corporations. The study made the following findings with respect to the plan's funded status based on the market value of plan assets and the plans' accumulated benefit obligations (which "more closely approximate the funding target under new funding rules" than other measures used for accounting purposes):

	<u>End of 2006</u>	<u>End of 2005</u>	<u>End of 2004</u>
Median funded status:	104.9%	97.9%	96.2%
Aggregate surplus/(deficit):	\$73.9 billion	(\$18 billion)	(\$34.1 billion)

Thus, a \$34.1 billion aggregate deficit as of the end of 2004 has become a \$73.9 billion aggregate surplus as of the end of 2006. We recognize that interest rates and the markets can swing at any time, but the clear upward trend and the large current surplus help provide us the ability to have a reasonable one year delay in the effective date of

the PPA's funding rules without jeopardizing benefit security or the PBGC's insurance system.

### **Phase-in of the Funding Target.**

A second important issue also relates to the transition from the old funding rules to the PPA funding rules. Under pre-PPA law, the funding target with respect to a defined benefit plan was, in a very general sense, 90% of a plan's liability. The PPA increased the 90% figure to 100%, subject to the following phase-in: 92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011 and thereafter. However, the phase-in was limited to existing plans that (1) were not subject to the deficit reduction contribution ("DRC") rules in 2007, and (2) were at the phased-in funding target in the current year and each year since 2008. Because of the second requirement, the transition rule has an unusual and very harsh effect.

Assume, for example, that in 2008 a plan has \$20 billion of liability and \$18.4 billion of assets. Such a plan is 92% funded; because that is the phased-in funding target for 2008, the plan would have no funding shortfall to amortize for 2008. Assume that a second plan has the same \$20 billion of liability but only \$18 billion of assets, *i.e.*, \$400 million less than the first plan, so the plan is 90% funded. One would think that the second plan would have a \$400 million shortfall, but that is not how the transition rule works. Because the second plan is funded below the phase-in level, the phase-in does not apply at all, so the second plan's shortfall is determined by reference to a 100% funding target. Thus, although the second plan has only \$400 million less than the first plan, the second plan has a shortfall of \$2 billion compared to no shortfall for the first plan. A \$2 billion shortfall would require an amortization payment of over \$300 million.

A national consulting firm analyzed this transition problem and reached the following conclusions. For a typical 90% funded plan, like the one above, the absence of a meaningful transition rule could cause funding costs to double or triple in 2008, as compared to 2007. For an 85% funded plan, for example, the increase will be even greater. *Companies cannot absorb this type of increase. Again, we refer back to the precarious state of the defined benefit plan system. In this context, a huge sudden increase in costs will likely cause many companies to eliminate 2008 benefit accruals and to freeze benefits generally. Eliminating the cost of 2008 accruals would be the only way for companies to soften the blow caused by the lack of a real transition rule. Generating more plan freezes is inconsistent with the intent of PPA in enhancing retirement security and would be an unfortunate result of a transition rule intended to mitigate the disruptions of moving from one funding regimen to a new one.*

Congress has consistently tried to combine important reforms with practical transition rules that make new obligations manageable. We feel confident that Congress could not have intended the result described above. To achieve the real

objectives of the PPA, the transition rule should be modified so that the funding target for all non-DRC plans is phased in.

### **Asset Smoothing.**

One of the key policy discussions with respect to the PPA was the extent to which smoothing of interest rates and asset values would be permitted. Asset smoothing provides an employer with greater predictability with respect to the value of its pension assets and thus greater predictability with respect to its funding obligations. If an employer's funding obligations were subject to the constant fluctuations of the market, funding obligations would be so unpredictable that business planning would be exceedingly difficult. Since that unpredictability is a key reason for pension plan freezes and terminations, it is essential that asset smoothing be preserved. And, smoothing strikes a reasonable balance between the long term obligation of pension plans and the continuing desire to keep a plan well-funded on a current basis.

The PPA preserved a degree of predictability by preserving interest rate and asset smoothing, but PPA reduced the smoothing period from 48 months under pre-PPA law to 24 months. (Other reforms to the smoothing rules were also adopted.) The problem is that with respect to asset smoothing, the PPA used the term asset "averaging", rather than asset "smoothing". The legislative history of the PPA is extremely clear that the use of the term "averaging" was intended to refer to smoothing. And the pension plan community clearly contemplates that 24-month asset smoothing is permitted by PPA. But if "averaging" is interpreted in a very technical sense, it has a different meaning. Technically, the term "average value" under current law refers to a valuation technique that is not commonly used because it systematically undervalues plan assets. For example, assume the following facts (which assume a 7.5% rate of return):

FMV of assets on <u>1/1/09</u>	FMV of assets on <u>1/1/10</u>	FMV of assets on <u>1/1/11</u>
\$100	\$107.50	\$115.56

Assume further that the increase in value is attributable to unrealized appreciation. In that case, the "average value" of plan assets on 1/1/11 would be the average of three values cited above, *i.e.*, \$107.69. That is 6.8% below the fair market value of \$115.56. Assets would be consistently undervalued if average value were used.<sup>5</sup>

By understating asset values, "average value" would artificially increase funding obligations. Thus, if employers could only choose average value or fair market value, they would effectively be forced to use fair market value. The use of fair market value

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<sup>5</sup> If some of the increased value is attributable to other sources, such as interest or dividends, there is less undervaluation, but there is definitely still undervaluation.

would lead to an enormous increase in volatility, resulting in many more plan freezes and terminations.

Congress needs to clarify in a technical correction that asset smoothing, not asset averaging, was intended. Asset smoothing allows plans to take unexpected gains or losses into account over a 24-month period (rather than both expected and unexpected gains and losses). Over time, asset smoothing neither understates nor overstates asset values. On the contrary, over time, the average of a plan's smoothed values is the same as the average of the plan's fair market values.

More specifically, 24-month asset smoothing would work as follow. *The following example works exactly the same as under current law except that the smoothing period is reduced from 48 months to 24 months.* A plan would determine its expected rate of return based on historical experience and its current investments. Assume that expected rate of return is 7.5%. If actual returns are greater than 7.5%, one third of the "excess return" would be taken into account on each of three valuation dates (separated by 24 months) until the entire excess has been taken into account. Similarly, if actual returns are less than 7.5%, one third of the "shortfall" would be taken into account on each of three valuation dates. For example, assume a plan begins smoothing assets as of 1/1/10:

	<u>Asset FMV</u>	<u>Return for next 12 months</u>	<u>Excess return</u>	<u>Shortfall</u>	<u>Smoothed assets</u>
1/1/09	\$100	10.5% (\$10.50)	\$3	NA	NA
1/1/10	\$110.50	4.79% (\$5.29)	NA	\$3	\$108.50 <sup>6</sup>
1/1/11	\$115.79	7.5% (\$8.68)	NA	NA	\$116.79 <sup>7</sup>
1/1/12	\$124.47	7.5% (\$9.34)	NA	NA	\$125.47 <sup>8</sup>
1/1/13	\$133.81				\$133.81 <sup>9</sup>

This example was structured to illustrate a basic point about smoothing. If a plan earns its expected rate of return over time, smoothing does not overstate or understate values, but rather just smoothes out asset value fluctuations, both negative and positive fluctuations. As illustrated, for example, where the plan earns its expected

<sup>6</sup> This is determined by starting with the "expected assets" of \$107.50 and then adding 1/3 of the \$3 excess return.

<sup>7</sup> This is determined by starting with the last year's smoothed value (\$108.50), then adding the expected return of \$8.29 (which is 7.5% of \$110.50), then adding 1/3 of the 2009 excess return, and finally subtracting 1/3 of the 2010 shortfall.

<sup>8</sup> This is determined by starting with the last year's smoothed value (\$116.79), then adding the expected return (which is 7.5% of \$115.79), then adding 1/3 of the 2009 excess return, and finally subtracting 1/3 of the 2010 shortfall. In 2111, the plan earned its expected rate of return, so no adjustment is needed with respect to 2111.

<sup>9</sup> This is determined by starting with last year's smoothed value (\$125.47), then adding the expected return (which is 7.5% of \$124.47), and then subtracting 1/3 of the 2010 shortfall. Again, in 2112, the plan earned exactly its expected rate of return.



rate of return for two years (2111 and 2112 in this example), market value and smoothed value will be the same in the following year (2113 in the example).

*As noted, we strongly believe that clarifying the asset smoothing rule is a technical correction. But it is a technical correction of such impact that it merits discussion here.*

### **Lump sums.**

Very generally, the PPA prohibits underfunded defined benefit plans from paying lump sum distributions in full. More specifically, a plan that is at least 60% funded but less than 80% funded can only pay ½ of a participant's lump sum (or the present value of the maximum PBGC guarantee, if less). If a plan is less than 60% funded, no lump sum may be paid. This rule was clearly targeted at a serious problem area, but unfortunately the rule has a very significant problem.

The PPA requires after-the-fact notice to participants that a restriction on lump sums has taken effect. Many companies will be very uncomfortable only providing after-the-fact notice. In the case of an older employee who has been planning to retire in, for example, May of 2008 based on a contemplated lump sum benefit, it seems very harsh to tell him or her on April 30, 2008 that as of April 1, 2008 lump sum distributions are no longer available. At least a very significant number of companies may feel that advance notice is appropriate from a fairness, employee relations, and/or fiduciary perspective.

So let us work through an example. A company has had business problems and its prospects are uncertain. Its workforce is aging and its plan is poorly funded. Such a company announces in late 2007 that lump sums may not be available starting either January 1, 2008 or April 1, 2008. The workforce reaction is very predictable, as evidenced by recent events with respect to a well-publicized bankrupt employer. Older, longer-service employees with large lump sums will retire in droves, creating an enormous drain on plan assets and a crippling brain drain for the company. In fact, there may not be any single event that could have a worse effect on the plan or the company.

The lump sum rule was well-intentioned but it will clearly cause exactly the problem it was intended to prevent. However, developing a solution to this problem is difficult. The need to restrict lump sum distributions by underfunded plans is understandable. The challenge is to create a rule that does not make the lump sum problem worse, as we fear the current rule does.

We suggest Congress consider the following restriction on lump sum distributions. If a plan is less than 80% funded, the maximum lump sum permitted would be equal to the product of (a) the lump sum otherwise payable to the participant, multiplied by (b) the plan's funded percentage. For example, assume that a plan is 75%

funded and a participant would otherwise be entitled to a lump sum distribution of \$100,000. In that case, the maximum lump sum would be \$75,000.

This rule makes policy sense from two perspectives. First, it is less likely than the current rule to produce the “rush to retire” because the restriction is less severe. Second, the restriction exactly fits the problem. In other words, the problem with lump sums is that, in the context of an underfunded plan, paying one participant 100% of his or her benefit is providing that participant with more than his or her proportionate share of plan assets, leaving other participants with less than their original proportionate share. Under our proposed alternative, all participants get exactly their proportionate share.

This is not an issue that is coming from our membership. This is coming from us as practitioners and advisors. We see the lump sum rule creating very unfortunate situations down the line and we hope that it can be fixed before that happens.

We appreciate the opportunity to offer views on these issues and would be pleased to assist the Committee or Subcommittee in these efforts.