JOINT TESTIMONY OF

KENNETH W. PORTER

ON BEHALF OF THE

AMERICAN BENEFITS COUNCIL

BUSINESS ROUNDTABLE

COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

ERISA INDUSTRY COMMITTEE

FINANCIAL EXECUTIVES INTERNATIONAL

NATIONAL ASSOCIATION OF MANUFACTURERS

US CHAMBER OF COMMERCE

BEFORE A JOINT HEARING OF THE

HOUSE WAYS AND MEANS SUBCOMMITTEE ON
SELECT REVENUE MEASURES AND
THE HOUSE EDUCATION AND WORKFORCE SUBCOMMITTEE ON
EMPLOYER-EMPLOYEE RELATIONS
UNITED STATES HOUSE OF REPRESENTATIVES

ON PENSION SECURITY AND DEFINED BENEFIT PLANS: THE BUSH ADMINISTRATION'S PROPOSAL TO REPLACE THE 30-YEAR TREASURY RATE

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Chairmen of the Subcommittees and Members, thank you for the opportunity to present the joint views of the American Benefits Council, the Business Roundtable, the Committee on Investment of Employee Benefit Assets, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the US Chamber of Commerce – organizations that represent a broad cross-section of American business and pension plans. My name is Kenneth W. Porter, Director, Global Benefits, Dupont Co. I am serving as a spokesman today, however, for these organizations, each of which has a vital interest in encouraging the creation of a regulatory climate that fosters the voluntary creation and maintenance of defined benefit pension plans for employees, and which come before you today with a common voice.

In our view, the need to replace the obsolete 30-year Treasury bond interest rate used for pension calculations is the most pressing issue facing employers that sponsor and individuals who rely on defined benefit pension plans today. Immediate action is required to correct the problem.

We commend the Bush Administration for stepping forward with a set of principles that recognize the need for permanent replacement of the obsolete 30-year Treasury bond rate. In particular, we are pleased that the Administration included in their recommendations the replacement of the 30-year Treasury bond rate with a conservative, high-quality corporate bond rate. The use of a composite corporate bond interest rate to replace the 30-year Treasury rate has been widely discussed for almost a year, enjoys strong, bipartisan backing, and has support across the ideological spectrum. Use of a composite, high-quality corporate bond rate will appropriately measure pension liability, will improve predictability of plan obligations, and is consistent with the pension rules previously adopted by Congress.

We do not, however, believe that the addition of a "yield curve" concept referred to in the Administration's recommendations has been sufficiently developed or examined, nor do we believe that it will provide the certainty and clarity in defined benefit plan funding obligations

that is urgently needed to ensure the continued viability of our defined benefit pension system. Consideration of the fundamentally new and untested yield curve regime should only occur in the context of a very careful review of all the pension rules and with a better understanding of the macroeconomic consequences of such a change.

Under current law, employers that sponsor defined benefit pension plans are required to use the 30-year Treasury bond rate for a variety of pension calculation purposes, including plan funding requirements, calculation of lump sum distributions, and liability for variable premium payments to the Pension Benefit Guaranty Corporation (the "PBGC"). The various provisions of federal law requiring use of the 30-year Treasury bond rate for pension calculations were enacted in 1987 and 1994 when there was a robust market in 30-year Treasury bonds and the yields on those bonds were an acceptable proxy for corporate bonds and other long-term debt instruments. While a variety of rates were discussed, it was believed at the time the 30-year Treasury rate was first selected in 1987 that use of the rate would result in companies setting aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

Beginning in 1998, the U.S. Treasury Department began a program of retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year Treasury bonds altogether. With commencement of the buyback program, yields on 30-year Treasury bonds began to drop and to diverge from the rest of the long-term bond market – a divergence that increased precipitously after the October 2001 discontinuation. As a result of the shrinking supply of these bonds (particularly when coupled with continuing demand for the relative safety of U.S. government debt), the secondary market interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other long-term bonds. The Treasury Department itself has concluded, "[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities."[1]

[1] Testimony of Peter Fisher, Undersecretary for Domestic Finance, U.S. Department of Treasury, before the House Ways and Means Subcommittee on Select Revenue Measures (April 30, 2003).

The result of these low rates is to artificially but substantially inflate pension liabilities and consequently increase required pension contributions and PBGC premiums. The inflated pension contributions mandated by use of the obsolete 30-year rate exceed what is necessary to fund promised benefits and produce a series of disastrous results for employees, employers, and our economy as a whole.

More and more of the companies that confront these inflated and unpredictable contributions (which can often be several times greater than prior year contributions, due to the non-proportional nature of the pension funding rules) have concluded that they have no choice but to stop the financial bleeding by freezing or terminating their plans. Both terminations and freezes have truly unfortunate consequences for workers – current employees typically earn no additional pension accruals and new hires have no pension program whatsoever. Government data reveals that defined benefit plan terminations have continued to accelerate in recent years, with a 19% drop in the number of plans insured by the PBGC from 1999 to 2002 (from 39,882 to 32,321, down from a high of 114,396 in 1985). Just as troublesome, the statistics above do not reflect plans that have been frozen. While the government does not track plan freezes, reports make clear that these freezes are on the upswing in recent months. A major consulting firm reports that 21% of surveyed defined benefit plans intend to scale back benefits for current employees through a freeze or other mechanism and 27% intend to offer less generous benefits for new hires.

Today's inflated funding requirements also harm the economy as cash unnecessarily poured into pension plans diverts precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers are having to defer steps such as hiring new workers, investing in job training, building new plants, and pursuing new research and development. Yet these are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, and return the country to robust economic growth. Some employers may be forced to lay off employees in order to accumulate the required cash contributions. Moreover, financial analysts and financial markets are now penalizing companies with defined benefit pension plans because of the unpredictable future pension liabilities that result from uncertainty as to what will

replace the 30-year Treasury bond rate. The resulting pressure on credit ratings and drag on stock prices, which harms not only the company but also its shareholders, is a further impediment to strong economic growth.

Because of these problems and the fact that the use of an obsolete interest rate for pension calculations makes no sense from a policy perspective, Congress acted in the March 2002 economic stimulus bill to provide temporary relief that expires in 2003. Since 2002, the 30-year Treasury bond rate has only become progressively more obsolete, and the associated problems described above have become more grave. In short, the 30-year Treasury bond rate is a broken rate that must be replaced. To continue to base pension calculations on an obsolete interest rate undermines the very foundation of our pension laws and defined benefit plan system.

We strongly endorse replacing the broken 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. H.R. 1776, a comprehensive pension reform bill authored by Representatives Rob Portman (R-OH) and Ben Cardin (D-MD), includes a provision (section 705) that does exactly that.

A corporate bond composite rate steers a conservative course that fairly and appropriately measures pension liability. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. Such rates would also provide the kind of predictability that is necessary for company planning of pension costs. Moreover, use of a corporate bond blend would achieve transparency given today's daily publication of corporate bond rates and instant access to market information through electronic means.

Use of such a conservative corporate bond blend would ensure that plans are funded responsibly. Moreover, the strict funding requirements that Congress adopted in 1987 and 1994 would continue to apply. Substitution of a corporate bond blend would merely mean that companies are not forced to make the extra, artificially inflated contributions required by the obsolete 30-year Treasury rate. This is why stakeholders from across the ideological spectrum – from business to organized labor – agree that the 30-year Treasury rate should be replaced by a conservative, high-quality corporate bond blend.

The Treasury Department has also suggested that after two years of utilization of a corporate bond rate, a so-called "yield curve" concept should be adopted. While a fully developed yield curve proposal has not been issued and the specifics underlying the concept are unknown, it appears that it would involve a complicated regime under which the interest rates used for measuring pension liability would vary with the schedule and duration of payments due to each plan's participants.

Although neither we nor the Congress yet have sufficient detail to fully analyze the Treasury Department's yield curve approach, it is clear that a yield curve regime would represent a very significant change in our pension system. It would lack the transparency and predictability of a conservative corporate bond blend, and also not be as well understood. At a minimum, it raises a large number of policy concerns and unanswered questions that have not been adequately studied or addressed. Based on our current understanding of the concept, we are concerned that the yield curve would:

- ***Exacerbate funding volatility*** by making liabilities dependent not only on fluctuations in interest rates, but also on changes in the shape of the yield curve (caused when rates on bonds of different durations move independent of one another) and on changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, etc.). The "smoothing" techniques that allow employers to use the average of the relevant interest rate over several years in valuing liabilities to reduce funding volatility also would not be allowed.

- ***Increase pension plan complexity*** (already a significant impediment to defined benefit plan sponsorship) by moving from a system based on a single interest rate to a much more complex system that relies on a multiplicity of instruments with widely differing durations and rates.[2]

- ***Make it difficult for employers to plan and predict their pension funding obligations*** (another significant impediment to defined benefit plan sponsorship today).

- ***Result in less ability for a plan sponsor to fund pension plans*** while participants are younger because it would delay the ability to deduct contributions to periods when the workforce is more mature and declining. In addition, important flexibility would be lost by removing the corridor surrounding the interest rate (historically 90% to 105% of the averaged

[2] Although statements have been made that the yield curve adjustment would be simple and easy, the fact that the Treasury Department has failed to provide full details on the proposal, even after months of study, belies the simplicity of the proposal.

rate). The loss of such flexibility would make it harder for employers to fund their plans in times when corporate resources are more plentiful.

- ***Require use of bonds of durations with very thin markets*** (because few such bonds are being issued). As a result, single events (e.g., the bankruptcy of a single company unrelated to the plan sponsor) could affect the rate of a given bond index dramatically, thereby leading to distortions in pension calculations and even potential manipulation.

- ***Have uncertain macroeconomic effects*** on the economy as a whole and on particular companies, industries, and classes of workers.

- ***Involve a considerable delegation of policy authority*** by Congress to the Executive Branch since the entirety of the construction and application of the yield curve would apparently be left to the regulatory process.

- ***Not necessarily result in a more accurate measure of liabilities***, since the theoretically more "precise" plan-by-plan yield curve interest rate would not be accompanied by other similar plan-specific assumptions.

There also are many additional unanswered questions created by the Administration's yield curve concept. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest and conversion to annuities of employee contributions to defined benefit plans, and the payment of interest credits under hybrid pension plans. Many of these uncertainties raise serious policy issues. For example, if application of a yield curve resulted in higher lump sum payments for older workers compared to younger ones, that result must be examined closely to determine whether it would modify ERISA's vesting standards by increasing backloading of benefits. It is also unclear how, or even if, the yield curve concept would apply for purposes of calculating PBGC variable premium obligations, another very major and unaddressed policy question.

It is unrealistic to believe that all of these outstanding issues and concerns raised by the yield curve concept could be addressed in the short time in which Congress must act on a replacement

for the 30-year Treasury rate. Such an untested change – from our current rules that allow for an interest "corridor" and an averaged interest rate to a yield curve concept applied on a "spot" basis – would require a complete reevaluation of our pension funding rules (as today's rules are premised on these corridor and averaging features). In addition, it is unclear from the limited information available how the very significant issues of transitioning from a system based on corridors and averaging to a less flexible system would be resolved. At a minimum, to the extent that this type of major overhaul of our pension funding rules is considered, it should be done in the context of a more fundamental review through deliberative Congressional study and the regular legislative process.

We also want to briefly touch on other issues referenced in the Administration's pension reform principles – namely additional disclosure of pension information and a new idea that would mandate freezes in certain private-sector pension plans. First, it is important that any required disclosure be responsible and serve a clearly defined need. Disclosure that provides a misleading picture of pension plan finances or that is unnecessary or duplicative of other disclosures could be counter-productive. For example, the Administration's proposal to key disclosure off of a plan's termination liability could provide a misleading depiction of plan finances for ongoing plans that are reasonably well funded because these plans are not in any danger of terminating. This type of misleading disclosure could unnecessarily and falsely alarm plan participants, financial markets, and shareholders. Moreover, termination calculations of the type being proposed are among the most costly and administratively burdensome calculations a plan can be asked to perform. Similarly, the Administration's proposal to allow publication of certain information that today is provided on a strictly confidential basis to the PBGC whenever a plan is

underfunded by more than $50 million would provide yet another impediment to companies' willingness to sponsor defined benefit plans, and ignores the size of the plan and its assets and liabilities. For many pension plans with billions of dollars in assets and obligations, such a relatively modest amount of underfunding is often quite normal and appropriate. It should not be cause to trigger publication of information on an ad hoc basis that could again sound unnecessary alarm bells.

We also believe that the Administration's proposal that would freeze private sector pension plans and remove lump sum rights when a company reaches a certain level of underfunding and receives a junk bond credit rating requires careful review. While we appreciate (and share) the Administration's concerns about PBGC guarantees of benefit promises that are made by financially troubled companies, their proposal raises technical and policy issues that require further examination. For example, there is no definition of "junk bond" status provided, and there is a question of whether it is appropriate to mandate a cutback in participants' benefits based on a third-party's determination of credit rating. Moreover, it is not clear why employees should lose their rights to certain forms of benefit when their company experiences financial trouble.

We thank you for the opportunity to present our views. All parties agree that the immediate problem is clear – the need to replace the obsolete 30-year Treasury bond rate. The solution is to permanently substitute an interest rate based on a composite of high-quality corporate bond indices.

Once that problem is solved, we also look forward to working with your Committees and the Administration on a comprehensive discussion of the long-term funding challenges facing our pension system as well as proposals designed to provide additional protection to the PBGC. Let us emphasize that employers that responsibly fund their plans and pay PBGC's per-participant premiums share the same objective as the PBGC – ensuring a sound defined benefit system over the long-term. However, a failure to immediately deal with the 30-year Treasury rate anomaly through substitution of corporate bond blend threatens not only the future viability of our defined benefit retirement system but the economic recovery as well.