

**TESTIMONY OF LARRY ZIMPLEMAN**  
**ON BEHALF OF THE**  
**BUSINESS ROUNDTABLE**

**BEFORE A HEARING OF THE**  
**UNITED STATES SENATE FINANCE COMMITTEE**

**ON**  
**AMERICA'S PENSION SYSTEM**

**MARCH 1, 2005**

**JOINED BY THE**  
**AMERICAN BENEFITS COUNCIL**  
**AMERICAN COUNCIL OF LIFE INSURERS**  
**ERISA INDUSTRY COMMITTEE**  
**FINANCIAL EXECUTIVES INTERNATIONAL**  
**NATIONAL ASSOCIATION OF MANUFACTURERS**  
**US CHAMBER OF COMMERCE**

**Testimony of Larry Zimpleman, F.S.A., M.A.A.A.  
Principal Financial Group**

**on behalf of The Business Roundtable**

**Joined by the  
American Benefits Council  
American Council of Life Insurers  
ERISA Industry Committee  
Financial Executives International  
National Association of Manufacturers  
US Chamber of Commerce**

**Before a Hearing of The Senate Finance Committee**

**Washington, DC  
March 1, 2005**

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is Larry Zimpleman, and I am President of Retirement and Investor Services at The Principal Financial Group. I am a member of the Society of Actuaries and the American Academy of Actuaries.

Today, I am here on behalf of the Business Roundtable, an association of CEOs from the largest employers in the world. Principal Financial's Chief Executive Officer, Barry Griswell, is Vice Chairman of the Business Roundtable's Health and Retirement Taskforce. The American Benefits Council, the American Council of Life Insurers, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the US Chamber of Commerce also join in the themes expressed in this testimony and some of these groups will be submitting their own supplemental testimony.

Mr. Chairman, we commend you, Senator Baucus, and the other members of the Finance Committee for tackling the critical issue of defined benefit pension reform. Your past leadership on these and other retirement issues has led to many of the recent improvements that have strengthened our nation's retirement system, and we urge you to continue to be active in retirement issues. We want to work with Congress and the Administration to build a more robust defined benefit system.

The best way to protect pensions for future retirees and working Americans is for Congress to enact permanent rules that lead to a fair and stable system. The unexpected termination of the 30-year Treasury bond in 2001, and the subsequent temporary fixes to the interest rate used for pension calculations have made it impossible for employers to project future pension contributions. This uncertainty has significantly compromised employers' ability to make new capital investments, hire new employees, make R&D investments or take other actions that ensure the future of U.S. business. The current fix expires at the end of this year and it is imperative that Congress enact a permanent interest rate as soon as possible. In addition, uncertainty regarding the status of cash balance and other hybrid plans is stifling innovation and flexibility in pension plan design. Affirming the legality of these plans, which cover more than 7

million Americans, is a necessary step to a vibrant defined benefit system. Congress should act quickly to provide the certainty that is needed in both of these areas.

We agree that other targeted reforms are needed as well. Pension plans must be appropriately funded. Pension promises that are made are promises that must be kept because the retirement security of millions of Americans is dependent on those promises. Employers should not be able to make pension promises they should reasonably know they cannot keep. These practices pose a threat to participants and to the Pension Benefit Guaranty Corporation (the "PBGC"). But strengthening the PBGC should not happen at the expense of the defined benefit plan system or the economy. This testimony sets out some of the reforms that we believe should be made and details our concerns about other reform proposals.

First and foremost, any reform proposal should be measured by the benefits or consequences for the U.S. economy. It is in no one's interest for pension reform to disrupt our economy or the capital markets since a strong economy benefits workers, retirees, plans, employers and the PBGC. Ill-conceived changes in pension rules could drive employers out of the defined benefit system, eroding the retirement security of American workers. In the worst case, excessive changes could tip some employers into bankruptcy – costing those workers not only retirement savings but potentially their jobs. We owe it to those Americans and their families to ensure that changes, no matter how well-intentioned, are not counter-productive.

### **PRINCIPLES FOR REFORM**

We believe that reform in the defined benefit system should be based on following principles:

- **ENSURE THE CONTINUED SUCCESS OF THE DEFINED BENEFIT PENSION SYSTEM.** The pension system benefits millions of Americans, with over 34 million participants currently relying on single-employer defined benefit pension plans as a critical element of their retirement security. Reforms, no matter how well intentioned, should not drive employers out of the system.
- **AVOID DISRUPTING OR UNDERMINING THE ECONOMY.** Nearly \$2 trillion is held by private sector pension plans and the pension system accounts for 6 percent of all U.S. equity investments. It is essential that any reforms avoid abrupt and unnecessary disruption to the U.S. economy.
- **PROTECT EMPLOYER FLEXIBILITY.** To compete effectively and attract and keep skilled workers, employers must be able to tailor pension plans to the unique needs of their workers and the competitive environment in which they function. The flexibility to utilize varied pension plan designs, including cash balance and other hybrid plans, is imperative if we are to maintain a vital defined benefit system.
- **PROVIDE PREDICTABILITY IN FUTURE PENSION COSTS.** Pension policy must provide employers with the certainty that will allow them to make new capital investments, to hire new employees, and to make R&D investments.
- **PRESERVE RULES THAT MINIMIZE FUNDING VOLATILITY.** It is essential that any reforms reflect the long-term nature of pension promises and smooth liability and asset valuations.

Volatility in these calculations makes it impossible for employers to plan and make prudent business decisions, slowing the economy. Volatile pension funding rules can also exaggerate economic cycles, leading to deeper recessions and greater job loss during down times.

- **ADVANCE RULES THAT PROMOTE PENSION PLAN FUNDING.** The pension system should encourage employers to make contributions to their plans as early as possible and ensure there is no disincentive to fund plans in advance of future liabilities. We strongly support the proposals like those previously approved by this Committee to revise the tax deduction rules that prevent employers from contributing to defined benefit plans during good economic times.
- **PROVIDE TIMELY AND APPROPRIATE INFORMATION TO PARTICIPANTS.** Participants should have the information they need to evaluate their retirement security. Existing funding disclosure requirements should be enhanced to provide timely and useful information about retirement plans, while at the same time avoiding the creation of costly, confusing or misleading new requirements.
- **MINIMIZE THE MORAL HAZARD IN THE PENSION SYSTEM.** Plan sponsors that make pension promises they cannot keep only to “shift” their liabilities to the PBGC pose a hazard to other sponsors participating in the system. Careful consideration should be given to reforms that prevent benefit increases that are not likely to be funded within a reasonable period of time.

### **KEY ISSUES**

A few weeks ago, Secretary of Labor Chao and PBGC Director Belt released a broad package of proposals that would completely change the funding rules applicable to single-employer defined benefit plans. There are a number of themes in the Administration’s proposals that are consistent with the reform principles we recommend. For example, the Administration’s focus on better disclosure to plan participants is a goal we share. Similarly, proposals to change the tax rules to allow employers to make larger contributions during good economic times are long overdue.

On the other hand, some of the reform proposals represent an unnecessary wholesale departure from the existing rules. Starting from scratch exacerbates the risks. Most of the reform proposals were presented for the first time in the FY 2006 Budget Proposal. Without understanding the impact of the proposals as a whole, the damage to the system and our economy could be substantial. The following provides a more detailed analysis of certain key issues that are raised by the Administration’s proposals.

**Making the Long Term Corporate Bond Rate Permanent.** In our view, the need to permanently replace the obsolete 30-year Treasury bond rate used for pension calculations is the most pressing issue facing employers that sponsor, and individuals who rely on, defined benefit pension plans. Without a permanent interest rate fix, employers cannot project their pension costs beyond 2005 and make informed business decisions. Today, a long-term corporate bond rate averaged over four years is used on an interim basis to determine “current liability” for the funding and deduction rules and to determine unfunded vested benefits for purposes of PBGC variable rate premiums. However, the measurement rate defaults to the rate on the now defunct 30-year Treasury bond beginning in 2006 if no further action is taken. It is widely agreed that the 30-year Treasury bond is no longer a realistic measure of future liabilities and would

inappropriately inflate pension contributions and PBGC variable rate premiums, especially during times of historically low interest rates similar to the interest rate conditions we are experiencing today. A return to an inappropriate and inaccurate measure of pension liabilities and the resulting inflated contributions caused by the defunct 30-year Treasury bond rate would be devastating for the ongoing vitality of the defined benefit system and would be enormously disruptive for employers and the strength of the economy.

We believe the best way to protect the pension system for future retirees is to make permanent the long-term corporate bond rate that Congress adopted last year. As Congress has recognized, the long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. The long-term corporate bond rate reflects a very conservative estimate of the rate of return a plan can be expected to earn and thus is an economically sound and realistic discount rate. Plans generally invest in a diversified mix of equities and bonds. For long-term obligations, plans generally invest in equities because equities have historically earned a greater rate of return than bonds. For mid-term liabilities, plans generally invest in a mix of equities and bonds and, for short-term liabilities, plans invest more in short duration bonds. The net effect is that plan's have historically earned higher rates of return than even the rate of return on long-term corporate bonds. For this reason, the long-term corporate bond rate is a very conservative measure of liability.

We also believe that the interest rate used for determining the amount of lump sum distributions should be conformed to the interest rate used for determining liabilities. Under current law, lump sums cannot be less than the amount determined using the defunct 30-year Treasury bond rate. This artificially inflates lump sums, which has contributed to funding pressures, and we support using the long-term corporate bond rate to determine lump sum payments.

It is important that the permanent interest rate that is chosen for funding and lump sum purposes be a fair and stable rate. We appreciate that the Administration has stepped forward with a proposal that recognizes the need for permanent replacement of the obsolete 30-year Treasury bond rate. However, we remain deeply concerned that the yield curve aspect of the proposal could produce an effective interest rate that is too low and therefore will overstate liability. Relative to the weighted long-term corporate bond rate in effect this year, the Administration's proposal could increase pension liabilities for a typical mature plan by 10% or more. In some cases, the immediate liability increase could be even greater. For large plans, this could cost billions of dollars. These dollars are far in excess of what is needed to provide a high degree of certainty that plans have enough to pay benefits. Moreover, the shape of the yield curve itself, as it steepens and flattens over time, could have a dramatic impact on mature plans.

The consequences of excessive contribution obligations are painfully clear. This is precisely what happened when inflated pension contributions were mandated by the obsolete 30-year Treasury bond rate. Employers that confront inflated contribution obligations will have little 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 will not have a defined benefit plan whatsoever. Government data reveals that defined benefit plan terminations accelerated prior to the temporary long-term corporate bond rate fix in the Pension Funding Equity Act of 2004, with a 19% drop in the number of plans insured by the PBGC from 1999 to 2002. 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 were on the upswing.

Inflated pension contributions also divert precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers will not hire new workers, invest in job training, build new plants, and pursue new research and development. These are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, and generate robust economic growth.

There are also questions about whether the interest rate changes proposed by the Administration can stand the test of time. Current law requires employers to make contributions equal to the greater of contributions required under the deficit reduction contribution rules (the "DRC rules") or the ERISA funding rules. The proposal would eliminate the ERISA funding rules and replace the current system with a single-tiered system modeled on the DRC rules. The ERISA funding rules play an important role because they reflect that for liabilities that span many years, providing a specific value on a specific day has little meaning in today's volatile market environment. Because the ERISA rules use a long-term interest rate to value liabilities, the ERISA rules remain an appropriate measure of liability for many defined benefit plans. The proposal to eliminate the ERISA funding rules could lead to serious underfunding in a high interest rate environment.

Moreover, even with the proposed increase in permissible deductible contributions, employers would be prohibited from adequately funding their plans in high interest rate periods -- contributions that would be permitted under today's rules. As we have modeled the yield curve proposal, there are significant periods over the last few decades in which contributions would not have been possible. For example, during the early 1980s when many companies made significant contributions to their plans, the Administration's interest rate proposal would have barred many of these companies from contributing.

Finally, we would note that the Treasury's yield curve methodology would also add complexity to an already overburdened system. The proposal would generate a series of interest rates for each participant. This level of complexity may be manageable by large employers, particularly sophisticated financial employers. However, it would impose a substantial burden on small and mid-sized employers, and even large employers that do not utilize a yield curve in their day-to-day operations. We also note that there are a myriad questions about the construction and composition of the yield curve. The proposal is intended to reflect the market. However, the markets for corporate bonds of many durations are so thin that the interest rates used would need to be created internally by the Treasury Department. More generally, we are concerned that the interest rate constructed by the Treasury Department would be opaque and that it would be virtually impossible for employers to model it internally as part of corporate planning. This type of an interest rate would also be particularly difficult for Congress to oversee.

**Preserving Rules That Make Pension Funding Predictable.** Predictable funding rules are important because they allow employers to make long-term financial plans. Future pension costs can represent significant investments -- more than \$1 billion per year for some employers.

Financial decisions of this magnitude require planning and substantial lead time. This can only occur with predictable funding rules.

We are concerned that the Administration's proposal will dramatically increase the already volatile and unpredictable funding rules by moving to a spot valuation of liabilities based on interest rates for the preceding 90 business days. In contrast, under current law, pension liability is valued using a weighted average of interest rates for the preceding 4 years. The use of a spot rate to value liability is one of a number of features of the Administration's proposal that would move plans towards mark-to-market measurement, including, for example, the proposed elimination of actuarial valuations of assets and proposed imposition of PBGC variable-rate premium obligations any time a plan is less than 100 percent funded on a spot basis.

As a threshold matter, it is critical to recognize that spot valuations do not mean tougher funding standards. Total funding remains the same; the spot or smoothed rate only affects when contributions are due and the degree of volatility associated with those contributions. As interest rates rise, a spot rate will result in smaller contributions and vice versa. Over the long-term, contributions are the same. Further, spot valuations are neither accurate nor meaningful for pension liabilities that span many years. A spot interest rate for 90 days is not a particularly accurate measure of liabilities that in many cases span more than 40 years.

As we have begun to model the Administration's proposals based on information provided to date, declines in funded status of 10% or more from year to year would not appear to be out of the ordinary. For most employers, such a swing would mean a dramatic increase in funding, regardless of any amortization of the shortfall. The pension funding rules are already unpredictable and volatile and many sponsors have opted out of the system because of this lack of predictability. Surveys suggest that employers view this as the top impediment to maintaining a defined benefit plan. For this reason, we are concerned that the spot rate proposal could have disastrous consequences for the ongoing vitality of the system.

We are also concerned that the proposed use of a spot rate could have very negative implications for the U.S. economy. Spot valuations require larger contributions during economic downturns and smaller contributions during economic upturns. Larger contributions reduce capital spending. This exaggerates downturns and upturns. The result is that the economy overheats during upturns and has deeper recessions during downturns. In economic terms, spot valuations have a "procyclical" effect on the economy. Research done at the request of the Business Roundtable indicates that the use of the spot rate relative to current law would have significantly exaggerated the most recent economic downturn.<sup>1</sup> For example, econometric modeling<sup>2</sup> suggests

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<sup>1</sup> Results of a study prepared by Robert F. Wescott, PhD. Dr. Wescott is an economist who works on macroeconomic, financial, and pension savings issues. Dr. Wescott served as Chief Economist at the Council of Economic Advisers and as Special Assistant to the President for Economic Policy. The study was reviewed by Professor Deborah J. Lucas, Household International Professor of Finance, Department of Finance, J.L. Kellogg Graduate School of Management, Northwestern University, and Professor Stephen Zeldes, Benjamin Rosen Professor of Economics and Finance at Columbia University's Graduate School of Business, and chair of the school's Economics Subdivision.

that a spot rate would have cost the economy more than 300,000 jobs during 2003. This would not have meant improved funding over the long haul, only exaggerated economic cycles and job losses.

Some have suggested that defined benefit plans can manage the lack of predictability in a spot rate proposal by investing in bonds and financial derivatives that hedge against interest rate movements. Hedging can be very expensive and plans should not be effectively forced to incur this cost. For many defined benefit plans, their investment policy committee does not allow the use of any form of derivatives. Even for plans that want to hedge, it is far from clear that there ever could be enough bonds or other instruments to permit plans to hedge their liability against interest rate movements. For example, hedging in bonds would require using the particular class of bonds that compromise the relevant interest rate benchmark. The Administration's interest rate is comprised solely of AA bonds and it is doubtful that there would ever be a deep enough market in this particular class for many plans to effectively hedge. Further, there are a limited number of derivatives issuers and a significant movement towards derivatives would concentrate risk within a handful of financial institutions. The potential consequences of concentrating risk within a limited number of counter-parties needs to be carefully considered before any fundamental change of this type is considered. Moreover, it is simply not possible to truly immunize because pension liabilities that depend on life expectancy cannot be hedged with bond portfolios. While this may be less of an issue for very large plans with large pools of participants, it would be a very significant problem for small and mid-sized plans. Since retirement plan liabilities depend in part on business prospects affecting when individuals retire, including elections of early retirement subsidies, it is impossible to precisely calculate the duration of plan liabilities.

More importantly, if a fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it could have a marked effect on the stock market, the capital markets, and capital formation generally. These effects need to be carefully considered because the consequences could be staggering. The volume of defined benefit plan assets held in equities is substantial. At the end of 2003, private sector defined benefit plans held equities worth about \$900 billion, compared with total U.S. equity capitalization of about \$15 trillion. This represents more than 6% of equity market capitalization. There is no historical experience with a portfolio shift of this magnitude to serve as a guide and the market impact is extremely difficult to predict. In general, an effectively forced sale of equities into bonds would work in the direction of depressing stock prices and raising bond prices. Higher bond prices would push down yields, further compounding the funding pressure because lower stock prices would depress asset valuations and lower bond yields would increase plan liabilities.

***Eliminating Barriers to Prefunding.*** One aspect of the Administration's proposal that we strongly support is the proposal to reform the tax rules governing the deductibility of pension plan contributions. We are pleased that this Committee has previously approved improvements in the deduction rules. Existing tax rules that prevent employers from making pension

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<sup>2</sup> The INFORUM Model, developed and maintained by economists at the University of Maryland, is one of the leading econometric models of the U.S. economy. The INFORUM Model is highly regarded for its simulation properties and its ability to capture the likely economic impacts of policy changes.

contributions at appropriate times during the business cycle must be eliminated. Employers need to be able to fund up their plans when they have the capacity to do so.

We support increasing the deduction limit to 130% of liability. Equally important, we note that the combined plan limit on deductible contributions, which limits the deductions for an employer who maintains both a defined benefit and a defined contribution plan, needs to be adjusted. Otherwise, the current 25% of compensation rule will inappropriately limit deductible contributions for plans with large retiree populations relative to the current working population. In addition, we strongly recommend repealing the excise tax on nondeductible contributions. Finally, we recommend providing employers with flexibility in timing the year in which deductions are claimed. Under present law, pension contributions can be deductible in the year of contribution or, in the case of contributions made before the due date for the prior year's return (including extensions), the prior year. This inflexible rule can prevent adequate funding. For example, an employer with expiring foreign tax credits may have little choice economically but to defer pension contributions for a year, in order to keep its taxable income high, which is a bad policy result. By allowing corporations greater flexibility on when to deduct, they will be more likely to contribute when they can and will be less worried about corporate tax capacity.

**Encouraging Advance Funding.** We are also concerned about elements of the Administration's funding proposal that could discourage employers from contributing more than the minimum required contribution. Under current law, if a company makes a contribution in excess of the minimum required contribution, the excess plus interest can be credited against future required contributions. This credit for prefunding helps to mitigate volatile and unpredictable funding requirements by allowing and encouraging a sponsor to fund up during good times. The proposal, however, does not give employers who prefund direct credit for their excess contributions.

There have been suggestions that the current law credit balance system has been a factor in terminating plans assumed by the PBGC. These suggestions ignore the fact that but for the credit balance system, companies would have contributed less, resulting in more underfunding and more liabilities assumed by the PBGC. Critics have also pointed out that credit balances are not immediately adjusted if the underlying value of the assets decreases. Consequently, plans with poor investment results have been able to use credit balances that no longer exist to meet their minimum required contributions. We support carefully targeted reforms that address this investment result problem. These reforms must be administrable and need to be applied prospectively. It would be fundamentally unfair to change the rules retroactively for employers that made contributions in reliance on current law credit balance rules. It is critical, however, that we preserve appropriate incentives to advance fund. Without these incentives, there is a significant risk that employers will only pre-fund to the minimum required by law. The result would be a less well-funded system, which is in no one's interest.

**Avoiding Unnecessary Bankruptcies.** Another issue that has been raised is whether it is prudent or feasible to base a retirement plan's rules on the determination of the creditworthiness of the plan sponsor and the members of the sponsor's controlled group. The PBGC has proposed basing funding, PBGC premiums, and the benefits a participant can receive on credit ratings. In effect, the employer's liability is treated as increasing when the employer's credit rating slips, even though the plan's benefit payment obligations remain unchanged.

The use of credit ratings to determine funding or PBGC premium obligations could have significant macroeconomic effects. Such use would put severe additional pressures on employers experiencing a downturn in their business cycle. If the lower credit ratings create additional funding burdens and business pressures, that could lead to further downgradings, creating a vicious circle that drags a company down. This could well happen to a company that today is able to fund additional contributions to pull itself out of the underfunding problem and thus raise its credit ratings. In short, a creditworthiness test would make it more difficult for a struggling company to recover. That is not in anyone's interest, including the PBGC, which could be forced to assume plan liabilities if the company does not recover. We must be careful not to lose sight of the fact that the best insurance for plans, participants and beneficiaries, and for the PBGC is a healthy plan sponsor.

It is also clear that the PBGC's proposal would classify many plans as at risk that will never be terminated. The mere fact that a company's debt is not rated as investment grade does not mean that it will terminate its plans. However, the consequence of these "false positives" could well be self-fulfilling, with employers forced to terminate as a result of a downward spiral. Moreover, employers that have non-investment grade debt but are improving their situation would get no credit for such improvement.

In addition, there are only a handful of credit rating entities and we are also concerned that a creditworthiness test would inappropriately vest these entities with enormous power. This is particularly troubling at a time when the credit rating agencies, and the credit rating process itself, have been the subject of significant criticism. These criticisms have raised questions about the credibility and reliability of credit ratings. In this context, a creditworthiness test is ill-conceived.

Finally, we also note that a creditworthiness test would inevitably result in the government determining the creditworthiness of at least some American businesses. Many privately held employers are not rated by any of the nationally recognized agencies and the PBGC has recommended conferring regulatory authority to develop guidelines for rating private companies. This would be unprecedented.

It is also important to recognize that an employer's credit rating is not directly tied to the plan's ability to provide the promised benefits. The plan is a separate entity and one of the hallmarks of U.S. pension law is that pension assets must be held in a separate trust or similar dedicated vehicle. A plan that has assets sufficient to pay benefits will pay those benefits even if the plan sponsor does not have adequate assets to pay its debts or otherwise has debt that is rated below investment grade.

**Providing Timely and Appropriate Disclosure.** We believe that participants should have timely and high-quality data regarding the funded status of their plans. It is important that participants have the information they need to evaluate their retirement security. These rules should be structured to provide full and fair disclosure without creating undue administrative burdens on plans or causing unnecessary concerns among participants.

In this context, existing disclosure requirements should be enhanced, while at the same time avoiding the creation of costly and confusing new requirements. Such an approach avoids the significant burdens of providing new documents to participants. A starting point might be the

Administration's general proposal to improve the summary annual report ("SAR"), but with significant modifications that would make the information disclosed more immediate and more meaningful. One of the problems with the SAR under current law is that the information disclosed is not timely, a problem which is not addressed by the Administration's proposal. In fact, currently, the information provided can be almost two years old. Accordingly, we would propose stronger changes.

All plans could be required to disclose in the SAR their funded percentage on a current liability basis. However, instead of reporting percentages as of the first day of the plan year for which the SAR is provided, the percentage could be reported as of the first day of the following year, using (1) the fair market value of assets as of that date and (2) the liabilities as of that date based on a projection from the preceding year. A plan maintained by a public company could also be required to disclose the year-end funded status of the plan as determined for purposes of financial accounting for the two most recent years available.

This approach would provide much more information than under present law or under the Administration's proposal. Information would also be based on the fair market value of plan assets, as well as a timely current interest rate in the case of financial accounting information. In addition, unlike the Administration's proposal, financial accounting information that is already circulated and disclosed could be used. By using information available to employees through financial reports and media statements, the possibilities for confusion would be greatly reduced.

**Funding the PBGC Appropriately.** The PBGC has openly stated that premium increases are in large part needed to fill the PBGC's deficit. While we fully agree that the PBGC has a significant deficit, the \$23 billion figure overstates the problem, and the required premium increases are, at best, premature and excessive. In addition to the fact that we continue to be in a period of historic low interest rates -- rates that temporarily inflate PBGC's liability, the PBGC uses an even lower interest rate (roughly 4.8%) to value its liability, thereby overstating its liability as well as ignoring possible future PBGC investment gains.

While we believe that reform is needed to address the growing deficits at the PBGC, we feel that the best way to deal with that problem is to keep more employers in the system, not to tax them out of the system. The PBGC proposes unprecedented increases in premiums, including a 60% increase in the flat rate premium, plus guaranteed future flat rate premium increases and effective increases in variable rate premiums, which many more plans would have to pay given the much larger definition of liability.

These massive premium increases would put a huge strain on plans. The PBGC's unprecedented proposal to index the flat rate premium for wage inflation, guarantees ever escalating PBGC premiums for all employers, even if the agency does not require the funds. In addition, the PBGC's unprecedented proposal to allow its board to set variable premiums would make it impossible for plan sponsors to predict premiums from year-to-year. Rising and uncertain premiums will force many plan sponsors, including especially small employers, to exit the system.

**Confirming the Legality of Hybrid Plan Designs.** Hybrid defined benefit pension plans, such as cash balance and pension equity plans, were developed to meet the needs of today's mobile workforce by combining the best features of traditional defined benefit plans and defined

contribution plans. Nearly a third of large employers with defined benefit plans maintain hybrids and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than 7 million Americans as of the year 2000. These plans are defined benefit plans and many of the same funding issues described above are relevant. They also face unique issues.

Despite the significant value that hybrid plans deliver to employees, current legal uncertainties threaten their continued existence. As a result of one court decision, every employer that today sponsors a hybrid plan finds itself in potential legal jeopardy. It is critical that this uncertainty be remedied and pension reform legislation needs to clarify that the cash balance and pension equity designs satisfy current age discrimination and other related ERISA rules. In addition to clarifying the age appropriateness of the hybrid plan designs, we believe it is essential to provide legal certainty for the hybrid plan conversions that have already taken place. These conversions were pursued in good faith and in reliance on the legal authorities in place at the time.

Some in Congress are seeking to impose specific benefit mandates when employers convert to hybrid pension plans. For example, some would require that employers pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others would require employers to provide employees the choice at the time of conversion between staying in the prior traditional plan or moving to the new hybrid plan. We strongly urge you to reject such mandates. Inflexible mandates will only drive employers from the system and reduce the competitiveness of American business. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans.

## CONCLUSION

In evaluating any change, the interests of tens of millions of American workers and retirees who rely on the private pension system as a critical element of their retirement security must remain paramount. Two badly needed changes must be enacted quickly to preserve that system. The first is the permanent adoption of the long-term corporate bond rate. The second is a rational framework for hybrid plans. There is substantial agreement on the need for both of these changes.

Given the size of private pension plans in the U.S. economy and the value of pension plans relative to other company assets, the consequences of other pension changes could be harmful for both the U.S. economy and American workers. Pension reform must not disrupt economic growth critical to workers, retirees, plans, companies or the PBGC. In particular, we are concerned that certain changes could have serious unintended macroeconomic costs.

- **SPOT RATES EXACERBATE ECONOMIC DOWNTURNS AND JOB LOSSES.** Proposals that move to a spot rate to value pension liability could intensify the cyclical nature of the U.S. economy -- deepening economic downturns and increasing job losses during recessions. A spot rate would cause pension liabilities to rise during recessions, forcing employers to make larger contributions and cut investment spending when the economy is at its weakest. We are very concerned that reductions in investment spending would deepen recessions and slow job growth.
- **VOLATILITY COMPROMISES LONG-TERM BUSINESS PLANNING.** Use of a spot interest rate to value pension liability and mark-to-market treatment of assets would also make the

funding rules even more volatile and unpredictable, without improving accuracy or plan funding. This could severely handicap the ability of employers to make long-term business plans. Proposals to eliminate credit balances, which provide a cushion against unpredictable volatility, would exacerbate this problem.

- **EXCESS CONTRIBUTIONS UNDERMINE INVESTMENT AND ECONOMIC GROWTH.** Requiring contributions in excess of what is reasonably and realistically needed to fund promised benefits could be incredibly disruptive to the economy, draining capital that would otherwise be used for investment and growth.
- **PROPOSALS COULD CAUSE UNNECESSARY BANKRUPTCIES.** Proposals that base contributions and PBGC premiums on credit ratings would create the potential for a vicious downward corporate spiral. If lower credit ratings create additional funding burdens and business pressures, that could lead to further downgrades, creating a circle that drags a company down that would otherwise recover. We are concerned this type of spiral could be disastrous for American workers and the economy. Similarly, for some employers, the increased cash flow burden associated with sudden inflated contribution obligations could force unnecessary bankruptcies with devastating consequences for workers and our economy.

We believe that reforms are needed to strengthen the system but that reforms will require considerably more discussion to avoid unintended results. We have outlined a number of specific ideas above and we urge the Committee to consider them.

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Mr. Chairman and members of the Committee, we thank you for the opportunity to present our views. We look forward to working with the Committee 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.