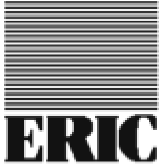

The ERISA Industry Committee

Advocating the Employee Benefits Interests of America's Largest Employers

1400 L Street N.W., Suite 350, Washington, D.C. 20005
phone 202-789-1400 / fax 202-789-1120 / e-mail eric@eric.org

TESTIMONY OF

THE ERISA INDUSTRY COMMITTEE (ERIC)

FOR THE
SENATE FINANCE COMMITTEE
HEARING ON

AMERICA'S PENSION SYSTEM

MARCH 1, 2005

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Mr. Chairman and Members of the Committee, thank you for the opportunity to present the views of The ERISA Industry Committee (ERIC) on the Bush Administration's proposals to reform voluntary single-employer defined benefit pension plans.

> ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

Since the mid-1990s, the Senate Finance Committee has been a leader in conceiving and moving to enactment legislation that improved voluntary retirement savings. For example, provisions of the Small Business Job Protection Act of 1996 (P.L. 104-188), the Taxpayer Relief Act of 1997 (P.L. 105-34), the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), and the Pension Funding Equity Act of 2004 (P.L. 108-218) supported retirement savings both by increasing opportunities for savings and by providing more rational rules for employers who voluntarily provide retirement plans to their employees.

Making EGTRRA Reforms Permanent

The Committee's leadership in the 1990s and beyond stands in contrast to legislation enacted during the 1980s when a host of limits, restrictions, and complicated rules were imposed on retirement savings plans as well as other employee benefit plans (see attached chart).

As a result of some of the changes enacted during that decade, funding for defined benefit pension plans was substantially delayed because employers' ability to project and begin to pay for future benefits was constricted through a series of new and reduced limits. Title VI of EGTRRA included provisions that partially reversed some of these funding constrictions, but the improvements will expire in 2010 unless extended by Congress. An extension of these modest improvements in pension funding was included in the President's budget. We urge that when this Committee and the Senate consider tax provisions expiring in 2010, the provisions improving pension funding be made permanent.

The Impact of Reform

The Administration has put forward a proposal to re-invent the rules governing voluntary defined benefit pensions. This sweeping proposal has some elements with which we agree but also contains many elements that will reduce retirement security by making it far more difficult for employers voluntarily to sponsor defined benefit pension plans.

The future of voluntary employer-sponsored defined benefit plans now is in Congress's, and this Committee's, hands. Whether at the end of the day employers are provided with a voluntary system that encourages them to establish, maintain, and fund pension plans – or whether they are faced with a system that discourages and even penalizes such actions will depend on the ability of Congress and stakeholders to find the right balance of rules and opportunities, risks and protections.

No system can be totally risk free and full proof. Any workable, sustainable system needs to balance legitimate concerns for security with equally legitimate concerns for business and economic competitiveness and flexibility.

This is an important conversation, and ERIC welcomes the opportunity to work with the Committee and the Administration to build a more robust voluntary defined benefit pension system.

A Sound PBGC

ERIC supports a soundly financed Pension Benefit Guaranty Corporation. As the PBGC has stated, the agency faces 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. Potential issues regarding the PBGC are long term issues.

In that regard, we note that of the $23 billion deficit published by the agency at the end of 2004, $17 billion (or nearly three-quarters) was due to claims that had not yet been received by the agency – called "probable" claims. Probable claims are those the agency expects to receive in the near future, although not necessarily in 2005. Thus, airline plans recently trusteed by the PBGC most likely are already included in this deficit calculation and do not increase any reported deficit. (See chart)

The Administration Proposal

The Administration proposes to replace the current-law long-term and short-term funding rules with funding rules based on spot measures of funded status as well as on the assumed financial health of the sponsoring employer; to modify disclosures made to the general public and to participants; to substantially increase premiums paid to the Pension Benefit Guaranty Corporation as well as the number of employers who pay a variable premium; and to restrict benefits available to participants in certain circumstances.

Permanent Interest Rate

ERIC strongly supports the Administration's proposal to provide a permanent interest rate that is based on corporate bonds, even though it disagrees with the specific construction of that rate chosen by the Administration (i.e., a yield curve). Uncertainty over the applicable interest rate has caused many plans

to be frozen over the past few years and impeded sound business planning. Providing stability in this key assumption is critical. Long-term corporate bond rates enacted by Congress for 2004 and 2005 provide a realistic picture of plan liabilities and reflect a very conservative estimate of the rate of return earned by pension trusts. The 2004-2005 solution should be enacted on a permanent basis.

Deductible Contributions
ERIC also strongly supports the proposals such as those put forward by the Administration that will increase limits on deductible contributions so that employers can fund up in good times and build cushions that will help them weather downturns. There are several proposals put forward by the Administration, Members of Congress, and stakeholders that deserve consideration. The specific provisions that will be most effective, of course, will depend on the final structure of the underlying funding rules chosen by Congress.

Disclosure
As stated in its principles, ERIC also agrees that more meaningful and current disclosure can be provided to participants, although we believe substantial modifications to the Administration's suggestions are needed.

Key Concerns

Volatility and Lack of Predictability
The current law long-term funding rules, which are based on long-term assumptions, allow companies to know well in advance what their funding requirements will be, and those requirements remain relatively stable over time. The current law deficit reduction contribution (short-term) rules, which are based on a rate averaged over four years, also allow companies to know at least a few years in advance when they may become subject to faster funding requirements.

Because it is based on spot measures of a plan's funded status, the funding construction proposed by the Administration eliminates a company's ability to predict its future contribution requirements. Under the Administration's proposal, a large plan's funded status also can swing back and forth between over funded and underfunded from year to year based solely on external macro-economic factors such as interest rates and short term market performance. The down swings can place cash calls on a company in the billions of dollars.

Pension plans are provided on a voluntary basis, and few companies will be able to tolerate that much risk exposure, especially in something that is not integral to their business product. To abate (but not eliminate) this risk, a company would have to radically overfund its plan and/or modify its investment allocations – and both of these make the plan far more expensive. At a minimum, benefits earned by participants will be reduced to keep overall costs level; in many instances, employers will be pushed out of the system.

We believe instead that the current-law long term rules should be made more effective and that the DRC rules should be made both more effective and less volatile.

Procyclical Impact

The current law DRC rules are designed to delay faster contribution requirements triggered by a normal recession until the economy has begun to recover. By contrast, the Administration's spot-rate scheme would exacerbate any downturn by imposing sharp cash calls well before recovery is under way.

The proposal ignores the fact that some plans will become somewhat underfunded during an economic downturn – and that this is normal and poses no risk to the PBGC. By designing rules that essentially require plans to be 100% funded at all times, the Administration has set a bar that is neither rational nor needed in the real world.

In addition, the Administration imposes an expansive definition of liability on any company that drops below investment grade. At a minimum, this part of the proposal is a strong incentive for employers not to sponsor defined benefit plans in the future. Besides the fact that many questions have been raised about how the rating companies operate, the proposed rules may in fact trigger the problems they are trying to resolve. They may trigger a plan termination – and, in the worst circumstances, cause the demise of the company itself. Structuring pension liabilities according to a company's credit rating will cause some companies to be downgraded, increasing their cost of doing business. For a company that is climbing to investment grade, the climb is likely to be much more difficult.

Many, many companies have been or will be below investment grade from time to time and will never terminate a plan that is trusteed by the PBGC. The proposal to base liability calculations on a sponsor's credit rating is like an ineffective and harmful medical test that has too many "false positives."

Complexity and Lack of Accountability

The Administration proposes to require use of a corporate bond yield curve that would be constructed monthly by Treasury staff. This is an extraordinary transfer of authority from Congress to agency staff.

Moreover, available markets in the sections of the yield curve that are most critical to most pension plans are thin – thus the staff must interpolate interest rates at those points. This will be very difficult for Congress to monitor, but it can have enormous impact on pension plan funding requirements.

Even though the Treasury will produce a single-page spread sheet of its yield curve, application of the curve is, in fact, complex. Estimates must be made decades into the future regarding the ages at which individuals will retire and the type of benefit distribution they will choose. Application of a yield curve to lump sum distributions also is complex and will be confusing to participants. The current law interest rate also is used in numerous other provisions of pension law – and a yield curve may not be suitable for all of these.

Use of a yield curve will unnecessarily increase the volatility of pension funding since both the interest rates in the curve and the curve itself will fluctuate.

In addition, while the Administration proposes interest rates theoretically tailored to each plan's expected payout, it would still require all plans to use the same mortality tables, creating for some plans a substantial imbalance.

Disincentives to Pre-fund
An employer who makes extra contributions will be in a worse economic position than an employer who does not if contributions above minimum requirements cannot count as pre-funding of future contributions. The Administration's proposal to eliminate credit balances should not be enacted. Available credit balances should, however, be adjusted if the underlying value of the assets decreases. This preserves a key incentive for employers to pre-fund their pension obligations during good times while eliminating a flaw in the current law that could allow a plan to use a credit balance even though poor investment results had erased its value.

Excessive Premium Taxes
The proposal has been scored as requiring plan sponsors to pay a startling $26 billion in additional premium taxes over the next ten years. Moreover, the proposal would index the flat-rate premium tax to wage growth (regardless of whether the agency needed the funds) and would allow the PBGC itself to set variable rate premium tax levels.

A premium tax increase of this size is not warranted. Moreover, both the indexing and the transfer of authority to the PBGC are inappropriate. Section 4002 of ERISA, states that the PBGC is to "maintain premiums...at the lowest level consistent with carrying out its obligations..." Automatic indexing, which would occur whether or not the PBGC needed the money, is inconsistent with this directive. It is wholly inappropriate for the PBGC to set the variable premium tax levels. Premium tax levels must balance the financial needs of the agency with the social goals of supporting a voluntary private pension system. Only Congress has the breadth of view and the recognized authority to make these judgments.

Principles Regarding Pension Funding and Financial Disclosure to Participants

At a time when members of the Baby Boom cohort are entering their retirement years, the government should assist employers who voluntarily sponsor retirement plans for their employees. Meeting the nation's retirement income needs is an important public policy objective that cannot be met by reliance on government, employers, or individuals alone. Employers offer several different forms of retirement savings vehicles, among them traditional and hybrid defined benefit pension plans in which employees accrue benefits without incurring the risk of investment loss. These plans remain vital to the ability of individuals to achieve financial security in retirement.

ERIC believes the Committee's actions should be based on the following principles governing pension funding and financial disclosure to participants:

Regulatory Environment: The federal government must create a regulatory environment that encourages the establishment, continuation, and long-term viability of defined benefit pension plans by providing plan sponsors with the certainty they need regarding –

* the interest rate used to calculate their liabilities;
* rules that support predictable and stable plan funding
* the validity of cash balance and other hybrid plan designs;

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In addition, rules governing pension plans must balance the interests of participants and of employers who voluntarily sponsor defined benefit plans. They must recognize the differences and need for flexibility among employers in plan design and the varying needs and interests of different workforces. Specifically:

* Legislation must be enacted as soon as possible that establishes a realistic and permanent interest rate assumption that appropriately measures the present value of pension plan liabilities and that, with an appropriate phase in, is applied to the minimum amount of any lump-sum distribution that a pension plan makes. The failure to change the current rate applicable to lump sums has resulted in lump sum distributions that are outsized relative to economic reality and the plan's funded status and has created an artificial incentive for participants to take their benefit in a lump sum.

* Pension funding standards must strike the appropriate balance that encourages employers both to establish and maintain defined benefit pension plans and to fund the plans on a reasonable and appropriate basis, thus protecting participants. This is essential to protecting the financial health of the pension system and the business vitality of plan sponsors. For example, legislation imposing additional requirements or benefit restrictions on plans less than fully funded should not be triggered by the credit rating of the sponsoring employer. This measure creates too many "false positives." It would impose unnecessary burdens on a large number of employers who otherwise are not likely to terminate their plans, making their business recovery more difficult and in some cases triggering the very plan termination that the funding rules should seek to avoid.

* Employers must not be discouraged from developing new plan designs that meet the changing needs of the current and future workforce. Legislation must be enacted that confirms the legality and facilitates the adoption and continuation of hybrid plans so that employers will be more likely to continue to offer pension plans.

* The Pension Benefit Guaranty Corporation (PBGC) must align its objectives with those of employers and participants since a flourishing private pension system is the best guarantee of the PBGC's long-term viability. In other words, as required under ERISA, PBGC must set policies and act to encourage the establishment and continuation of voluntary defined benefit plans. Plan funding and premium policies should not force employers out of the voluntary pension system prematurely and unnecessarily during periods of financial distress or normal economic downturns.

<u>Funding Objectives:</u> In order to ensure that employees will receive pension benefits from employer-sponsored plans, the primary objectives of funding standards must be to foster plan continuation through actuarially sound funding and to allow plan sponsors to anticipate systematic and stable funding over time.

* Required contributions must be both predictable and stable in order to facilitate capital

planning in the sponsoring business.

* Funding standards should permit the pre-payment of contributions when sponsors are able to do so.

* Funding standards must allow and facilitate diversification of investments of pension plan assets, including investments in equities, in order to ensure the growth and security of the plan.

* Funding standards must recognize the on-going and long-term nature of pension plans; the primary focus of funding requirements should be based on long-term measures and long-term assumptions.

* Short-term measures of a plan's funded status should be monitored and taken into account in funding and disclosure decisions, but also must balance funding goals with the need to avoid forcing plan sponsors to choose between funding their plans and maintaining the viability of their businesses.

Financial Disclosure to Participants: More meaningful and more current disclosure is needed. Summary annual reports are not meaningful. Investors receive better and more current information than do plan participants.

* Plans should be required to provide participants early each year with a statement of the plan's funded status based on timely information currently available -- such as information on plans compiled for SFAS 87 disclosures.

* The new report should replace the summary annual report.

* As under current law, plans may provide participants with additional information.

Underfunded Plans: To prevent the occurrence of benefit accruals that are not likely to be funded within a reasonable period of time and to reduce the PBGC's exposure to such benefit accruals, special restrictions on benefit increases and payouts should be imposed on plans that are severely underfunded and likely to terminate. This will limit cost shifting from failed plans to ongoing plans through increased PBGC premiums.

* Restrictions should be imposed on a graded scale – the most severe restrictions reserved for the most underfunded plans.

* Restrictions imposed on benefit accruals or lump sum distributions must be workable and as minimally disruptive of business operations, workforce management goals, and participants' needs as possible, and not invite or lead to lawsuits against employers.

Conclusion

To secure defined benefit pension plans and lay the groundwork for their expansion in the future, Congress must take action now to:

* adopt the long-term corporate bond rate as a permanent interest rate for calculating liabilities, and

* provide legal certainty for hybrid plans.

However, before enacting pension funding reforms, Congress must ensure that reforms result in rules that support predictable and stable plan funding.

The Administration has stated that it wants to ensure that plans are funded so employees will be assured of receiving their benefits. We agree. But aspects of the specific proposal put forward are so harsh, volatile and unpredictable that many plan sponsors will be forced to freeze their plans, and in some cases may be forced into bankruptcy. Moreover additional workers will not have the opportunity to earn pension benefits because their employer will not consider installing a defined benefit plan under such a structure.

The Administration also has stated it wants to avoid a taxpayer bailout of the PBGC. We agree. But the best assurance of a sound PBGC is a robust defined benefit system. We do not believe that the Administration's proposal accomplishes this goal and in fact may put the PBGC in a worsening position.

We appreciate the opportunity to present our views and look forward to working with the Committee and the Administration to provide opportunities for American workers to attain lasting retirement security.

BUDGET REDUCTIONS* AFFECTING EMPLOYEE BENEFITS

LAWS ENACTED 1982 - 1994

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 **(TEFRA) P.L. 97-248**
Lower limits to compute pension contributions and benefits (I.R.C.§415) from $136,425 and $45,475 to $90,000 and $30,000, frozen until 1986; reduce combined plan limit. Limit plan loans. Require plan distributions at age 70-1/2 or retirement. Reduce integration in defined contribution plans. Impose stricter leased employee rules. Impose new nondiscrimination rules on group term life insurance (I.R.C.§79).

Est. five year net revenue gain of $3.872 billion (1983-1987)
[Est. three year gain: $1.844 billion]

DEFICIT REDUCTION ACT OF 1984 (DEFRA) P.L. 98-369
Freeze §415 limits until 1988. Repeal PAYSOPs. Limit deductions for contributions to I.R.C.§501(c)(9) trusts (VEBAs). Impose limits on group term life insurance for retirees. Repeal estate tax exclusion for qualified plan benefits. Expand leased employee restrictions. Expand nondiscrimination standards for 401(k) plans. Restrict tax exclusion of fringe benefits and benefits available under cafeteria plans (I.R.C.§125 plans). Limit vacation pay; and make other changes.

Est. five year net revenue gain of $4.094 billion (1985-1989)
[Est. three year gain: $2.472 billion]

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985 (COBRA) P.L. 99-272
Require continuation health coverage ("COBRA coverage"). Increase PBGC premiums; restrict plan terminations.

Est. three year net revenue gain: $0.666 billion (1986-1988)

TAX REFORM ACT OF 1986 (TRA-86) P.L. 99-514
Limit deductions for business meals, travel, and entertainment. Restrict availability of IRAs. Impose cap on elective contributions to and impose new nondiscrimination rules on 401(k) plans. Impose tax on pre-retirement distributions. Repeal 10-year averaging. Repeal three year basis recovery. Reduce early retirement §415 limits. Reduce deduction limits for plan contributions. Impose 10% excise tax on reversions. Cap dependent care assistance. Impose nondiscrimination rules on welfare benefit plans. Limit ESOPs; and make other changes.

Est. five year net revenue gain of $50.299 billion (1987-1991)
[Est three year gain: $28.794 billion]

OMNIBUS BUDGET RECONCILIATION ACT OF 1987 (OMBRA) P.L. 100-203
Reform pension funding. Impose 150% of current liability cap on pension funding. Increase PBGC premiums; and make other changes.

Est. three year net revenue gain 1988-1990: $3.580 billion

TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 P.L. 100-647
Increase excise tax on reversions. Make numerous technical corrections. Change COBRA penalties. Modify Section 89; and make other changes.

Est. three year net revenue loss 1989-1991: $0.279 billion

OMNIBUS BUDGET RECONCILIATION ACT OF 1989 P.L. 101-239

Restrict ESOPs. Restrict prefunding of retiree health. Impose new mandatory penalty on violations of ERISA. Extend educational assistance and legal services. Expand COBRA; and make other changes.

Est. five year net revenue gain: $9.390 billion (1990-1994)

OMNIBUS BUDGET RECONCILIATION ACT OF 1990 P.L. 101-508
Allow transfers of excess pension assets to pay for retiree health benefits. Increase excise tax on pension plan reversions. Increase PBGC premiums. Extend user fees. Extend educational assistance and legal services; and make other changes.

Est. five year net revenue gain: $354 million (1991-1995)

BUDGET RECONCILIATION ACT OF 1993 P.L. 103-66
Repeal the Medicare hospital insurance (HI) taxable wage base cap. Reduce the amount of compensation that can be taken into account in computing pension contributions and benefits from $235,840 to $150,000. Extend educational assistance. Facilitate real estate investments by pension funds.

Est. five year net revenue gain: $30.398 billion (1994-98)
[Repeal of HI cap = $29.1 billion five-year revenue gain]

GATT IMPLEMENTATION ACT, 1994 P.L.103-465
Reform pension funding and provisions of law affecting the PBGC (including removing cap on variable rate premium). Extend retiree health transfers under IRC §420. Slow down indexing of plan limits.

Est. five year net revenue gain: $1.757 billion (1995-99)

IN ADDITION: For the past several years, each budget reduction has included billions of dollars in "savings" in federal payments under Medicare and Medicaid. This has resulted in increased charges to other payers (including employee benefit plans). The Prospective Payment Commission has estimated that costs to other payers have increased an average of 28%.

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* NOTE: The revenue estimates included in this memorandum are the estimates provided at the time of the bill's passage by Congress. They do not reflect subsequent changes in underlying tax rates or in other provisions of law. Several bills include benefit provisions that increase federal expenditures as well as provisions that reduce federal expenditures. The estimates included in this memorandum are net amounts.

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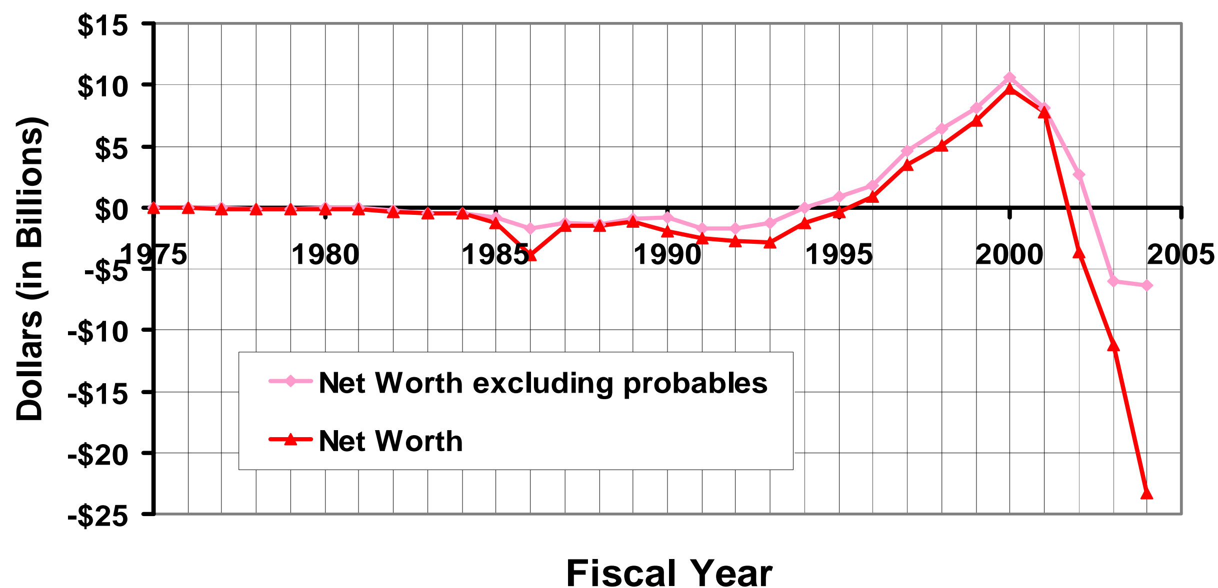
ERIC

Probables Drive New Numbers



Source: Ron Gebhardtsbauer, American Academy of Actuaries from PBGC filings