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A nonprofit association committed to the advancement of the employee benefit and compensation plans of America's major employers

STATEMENT OF

THE ERISA INDUSTRY COMMITTEE (ERIC)

FOR THE
COMMITTEE ON EDUCATION AND THE WORKFORCE
U.S. HOUSE OF REPRESENTATIVES

PENSION FUNDING, PBGC & HYBRID PLAN REFORM

JUNE 15, 2005

STATEMENT OF

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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 H.R. 2830, The Pension Protection Act of 2005, and H.R. 2831, The Pension Preservation and Portability Act of 2005.

> *ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and compensation plans of America's major employers. ERIC's members' plans are the benchmarks against which industry, third-party providers, consultants, and policy makers measure the design and effectiveness of these plans. ERIC has a strong interest in proposals affecting its members' ability to provide employee benefits, incentive, and compensation plans, their cost and effectiveness, and the role of these plans in the American economy.*

CHALLENGES BEFORE THE COMMITTEE

News media and other public forums, including hearings before this Committee, have been filled for months with reports of problems concerning the funding of defined benefit pension plans as well as reports of court challenges to defined benefit hybrid plans. In the midst of this surfeit of information, Congress must separate real from perceived problems and fashion solutions that will, when enacted, actually enhance the retirement security of American workers. Too often today reports of problems in specific industries have led to suggestions that the entire system needs to be reformed to meet the most egregious circumstances. The debate has become imbalanced. The vast majority of plans are not a threat to the PBGC – but harsh and volatile rules are a threat to the vast majority of plans and the businesses that sponsor them.

The introductory summary to The Pension Protection Act states:

> *Employers making major financial decisions must be able to predict and budget for their pension contributions every year or they'll simply freeze or terminate*

their plans and stop offering these voluntary benefits altogether. Workers also need to know that employers are making timely contributions to adequately fund their pension plans.

In this statement, the Chairman and the other sponsors of H..R. 2830 have correctly identified the challenge before the Committee. Pension funding rules are perpetually challenged by the need to balance the goals of affordability and security. These dual goals must be premised upon a realistic view of long-term pension liabilities, which no single snapshot can provide. Funding rules must secure benefits for workers, but they must also enable a company to allocate cash in its business in a way that ensures the continued viability and growth of that business.

Similarly, the introductory summary to The Pension Preservation & Portability Act states:

> *Cash balance pension plans – a type of defined benefit plan that is employer-funded, insured by the PBGC, and portable from job to job – represent an important component of worker retirement security....The threat of legal liability [associated with these plans] is creating ongoing uncertainty and undermining the retirement security of American workers.*

Again, the Chairman and other sponsors of H.R. 2831 have correctly identified the challenge before the Committee. Without legal certainty, innovative and popular benefits particularly suited to a mobile and dynamic workforce, including women, will disappear – and soon.

Employers and employees will continue to want defined benefit plans in the future. They are a very cost-effective way to provide real retirement income to workers. If you start with the same pot of money, larger benefits can be provided to individuals through a defined benefit program because longevity and investment risks are pooled and calculated over a longer period of time than any single individual's lifespan. In addition, the benefits do not fluctuate with investment performance or the economy. Employees appreciate and benefit from the certainty provided by having defined benefit plans in their retirement portfolio. Before their legal status was called into question, many employers were turning to hybrid defined benefit plans that are well-suited for the modern workforce, and some of these employers had never sponsored a defined benefit plan before. Under a rational and predictable regulatory scheme, recent declines in the numbers of defined benefit plans can be brought to a halt and perhaps reversed.

We discuss both bills in further detail below, beginning with H.R.2831.

H.R.2831, THE PENSION PRESERVATION & PORTABILITY ACT OF 2005

ERIC urges in the strongest possible terms that the Committee include the substance of H.R.2831 in the longer pension bill (H.R.2830) when it considers these matters in the next few weeks. The Congress can construct the most perfect funding rules possible – but without certainty for hybrid plans those rules are likely to apply to a rapidly dwindling universe.

Hybrid plans are important to workers' retirement security:

- Approximately 25% of defined benefit plans today are of hybrid designs.
- They provide secure retirement benefits to over 7 million American workers, and they are even responsible for about 20% of premium-taxes paid to the Pension Benefit Guaranty Corporation (PBGC).

But companies cannot rationally maintain these plans in the face of potential legal liabilities that increase by millions, or in some cases hundreds of millions, of dollars every year and that can result in large legal expenses even when a plan is exhonorated. The issue has been festering for years. Time is of the essence and the time for action is now. The cost of inaction is unacceptable.

The promise of action, however, is that employers will be able to maintain their plans and to consider installing these plans for their employees in the future. It bears repeating that hybrid plans are *secure* retirement plans –

- They are paid for by the employer;
- The investment risk is borne by the employer;
- The benefit is determined by a formula, not by the ups and downs of the economy;
- The benefit is guaranteed by the PBGC;
- Annuity payout forms must be offered by the plans;
- Benefits accrue ratably over time so that even shorter service workers receive a meaningful benefit;
- Benefits are easily portable; and
- Employees like, understand, and appreciate these plans.

It is very likely that, with legal certainty, even employers who do not now offer a defined benefit pension plan will establish hybrid plans for their employees. If this is the result, this Committee could rightfully be proud.

H.R.2831 recognizes, however, that legal certainty at too high a cost is counterproductive. If a premium is charged for certainty, employers will choose other routes to create a compensation package. In this regard, H.R. 2831 takes the only rational approach –

- It validates hybrid plan designs without regard to whether the plan already exists or is established in the future.
- It provides a transparent test for age discrimination in conversions that does not mandate that a conversion follow a specific formula and does not require additional benefits to be provided just because the employer is changing the plan for the future.
- It also resolves a technical issue (called "whipsaw") that has been used to penalize employers who provide generous interest credits under their plan.

A few key points in the debate over hybrid plans should be highlighted:

- The preponderance of courts have determined that hybrid designs are legal and that they do not discriminate on account of age. The reasoning in a district court decision that ruled otherwise has subsequently been rejected by another district court.
- Employees have not lost earned benefits during conversions. Under current law all benefits are protected once they are earned and vested.

- If the "whipsaw" is resolved as it should be, employees will benefit because plan sponsors will be encouraged to provide higher interest credits under their plans.

Our Members have discovered several technical issues raised by the wording of H.R.2831. WE will identify those issues to the Committee and its staff shortly. In addition, there are several important technical issues that are not presently addressed by the bill; these issues are outlined in an attachment to this Statement, and we urge the Committee to address them in the bill. However, let there be no doubt; we are here principally to applaud the clarity of the vision in the bill regarding what must be done and to urge enactment of H.R.2831 as a part of H.R.2830.

H.R. 2830, THE PENSION PROTECTION ACTOF 2005

ERIC PROPOSES ACTION:

The ERISA Industry Committee has a proud history of advocacy of sound pension funding. The organization came into being in response to the government's call for assistance in implementing the landmark 1974 Employee Retirement Income Security Act. It was instrumental in fashioning the backstop funding rules of 1987 and in revising those rules in 1994. We do come to the current debate both with a sense of history and an understanding of the need for responsible action.

This year, ERIC put forward comprehensive *Consensus Proposals for Pension Funding, PBGC Reform, and Hybrid Plans*. (See the complete proposal on ERIC's web site: www.eric.org.) Key provisions of ERIC's proposals are summarized below.

To improve funding, ERIC proposes –

- faster amortization for plan amendments that increase benefits;
- a higher funded ratio threshold below which companies must commence accelerated contributions;
- inclusion of lump sum benefits in the calculation of current liability and coordination of the discount rate used for funding with that used to calculate minimum lump sum distributions;
- preservation, with modifications, of an employer's ability to pre-fund required contributions;
- increases in the contributions that employers can make on a deductible basis, and
- increased incentives to fund up plans by allowing excess assets to be used to fund savings plan contributions on behalf of the pension plan's participants.

To improve disclosure, ERIC proposes –

- To provide participants with plan-specific information parallel to that provided on an aggregate basis to investors, thereby providing participants valuable information on their plans on a dramatically accelerated schedule compared to current law.

To protect the PBGC against rapid deterioration of a plan, in addition to the funding proposals outlined above, ERIC also proposes –

- Prohibiting amendments to increase benefits in sharply underfunded plans;
- Ensuring more rapid funding of shut down benefits and limit PBGC guarantees where opportunity to fund has been truncated by a bankruptcy,
- At bankruptcy, restricting PBGC guarantees and limiting payouts of lump sum and shut down benefits; and
- Provide greater incentives for employees to take benefits in the form of an annuity.

ERIC also believes that there should be greater flexibility in developing solutions for specific industries that will increase the likelihood that companies will be able to restructure their enterprise and avoid termination of their pension plans while also ensuring that the funded status of a company's plans does not worsen.

ASSESSING THE PROBLEM:

To determine the extent of the problem facing it, the Committee faces the difficult task of sifting through a confusing and sometimes misleading array of numbers describing the current and potential future state of pension funding and of the Pension Benefit Guaranty Corporation. The greatest danger is overstating the problem, for that could easily lead to enactment of harsh measures that themselves precipitate the problems they seek to avoid.

For example:

- In September 2004, the PBGC estimated that pension plans ensured by the agency were underfunded by $450 billion. The liabilities in this estimate are calculated as though every company involved were going to fail and be forced to terminate its plans. This simply is not going to happen. A recent analysis by Goldman Sachs states, "Quite frankly, if all of those sponsors were to fail, pension plan underfunding would be the least of the worries for the US economy and the capital markets."

- On June 7, the PBGC stated that underfunding in 1108 plans reporting to the PBGC increased from $279 billion at the end of 2003 to $354 billion at the end of 2004. However,
    - The same report also states that the funded ratio of these plans had remained virtually steady – 69.7% at the end of 2003 and 69% at the end of 2004. Thus their funded status actually appears to have remained virtually constant over this period.
    - From 2003 to 2004, the PBGC reduced the arbitrary interest rate it uses to calculate liabilities from 4.7% in 2003 to 3.8% in 2004, a 90 basis point drop that dramatically increased estimates of liabilities in plans reporting to it.
    - The same report also notes that assets in these plans increased substantially during 2004 – from $914 billion to $1.141 trillion – apparently enough to offset the increase in liabilities due to the change to a much lower discount rate. Use of a more reasonable discount rate would produce a different picture. Moreover, like

the $450 billion estimate, this estimate is predicated on all 1108 plans being terminated, an unrealistic assessment.

- The PBGC had a published deficit at the end of 2004 of $23 billion. If the agency used the yield curve interest rate proposed in the Administration's funding proposal, its deficit reportedly would have been $19 billion, a significant decrease.

- A June 7, 2005, Government Accountability Office report cited a drop in funding ratios in plans from 2000 to 2002, the latest date for which that agency had data. However, 2000-2002 includes the impact of the recent economic downturn, so the drop in the funded status of plans should not be a surprise. Initial evidence from 2003 and 2004, when the economy began to turn back up, presents a different picture.
  - One recent analysis shows assets of defined benefit plans at approximately $2 trillion at the end of 1999, dropping to $1.5 trillion at the end of 2002, but climbing back up to $1.8 trillion at the end of 2004. That's not back to full health yet, but the direction is encouraging.
  - While assets have increased in the last two years, some of their impact has been offset by a continued drop in long term interest rates, which Federal Reserve Chairman Alan Greenspan calls anomalous and unprecedented.

AVOIDING PITFALLS:

The sponsors of H.R.2830 have stated that, while the Administration's proposals are focused on the PBGC, their bill aims to provide a soundly financed system in which employers will maintain their plans rather than freeze or terminate them. We agree that this is the appropriate focus. Consider the following:

- Private sector defined benefit pension plans pay approximately $110-120 billion in benefits to retirees every year. By comparison, in 2004 the PBGC paid approximately $3 billion.
- Over 44 million Americans receive or will receive benefits from defined benefit plans. By comparison, the PBGC's present and future benefit population at the end of 2004 was approximately 1 million.
- The PBGC does not have a short-term crisis. At the end of 2004 it had resources sufficient to pay benefits for 20 to 25 years. In 2004 the PBGC received $1.5 billion in premiums and earned $3.2 billion on it assets – from which it paid $3.7 billion in benefits and administrative expenses. As new claims come in, the agency's asset base will continue to grow and it will also receive additional premiums.

H.R.2830, in supplanting a the Administration's short-term PBGC-focused view with a longer term objective of ensuring sound funding along with a robust defined benefit system, has avoided several key pitfalls in the Administration's approach.

- **Averaging and Smoothing:** Averaging of the funding discount rate and smoothing of assets are two concepts that are misapprehended in the current debate. These mechanisms were placed in the law not to obscure the status of the plan but to accomplish critical policy objectives. Specifically, because of current law averaging and smoothing, (1) the plan sponsor is better able to predict – and plan for – future cash contributions; (2) unnecessary and harmful volatility in cash calls on the company are somewhat ameliorated; and (3) accelerated funding requirements are less likely to occur as the country moves into a recession. Instead, the sharp cash calls on a company precipitated by accelerated funding waits until a short time later, typically as the economy begins an upturn. A February 2005 independent study conducted for the Business Roundtable showed that, if the Administration's spot rate and mark-to-market measures of assets had been the law, kicking in accelerated funding as the economy dropped into a recession in 2001 and 2002, the diversion of cash from business enterprises to pension funding requirements would have cost the economy 330,000 jobs in 2003 alone. In some cases, the lack of averaging and smoothing would have created a death spiral in companies, increasing, rather than reducing, liabilities faced by the PBGC. H.R.2830 wisely retains averaging and smoothing albeit for a shorter period of time than under current law. We caution, however, that further analysis of H.R.2830 is required to ascertain whether the funding scheme outlined in H.R.2830 will meet the critical funding policy requirements of predictability, stability, and economic compatibility.

- **Credit Ratings:** The Administration proposes that companies that fall below investment grade be required to fund their plans as though they were about to terminate. This is based on the faulty logic that a company's current investment grade determines the funded status of its plans as well as its ability to survive into the future. It does not. To the contrary, the increased call on the company's cash can easily precipitate the death spiral the proposal seeks to avoid. Moreover, the proposal raises the disturbing prospect of the U.S. government, not the marketplace, ruling on the financial soundness of companies, an unprecedented intrusion into the free market. H.R.2830 wisely rejects this approach, retains a more appropriate focus on the funded status of plans, and imposes additional requirements only on plans that are significantly underfunded.

- **Credit Balances:** The Administration proposals abolish credit balances, not only removing a key incentive for employers to pre-fund future required contributions but also breaking faith with companies that have pre-funded their obligations in the past. H.R. 2830 wisely retains the concept of providing credits for pre-funding, including, based on our understanding from conversations with staff, taking into account all assets in the plan, including those contributed in advance of minimum requirements, in computing the funded status of the plan for funding purposes. The bill addresses problems that have arisen by ensuring that the value of the available credit matches the underlying available assets and by limiting the use of pre-funding credits if a plan becomes substantially underfunded. While the bill retains this necessary component of sound funding policy, we are very concerned that, as drafted, the bill would subtract credit balances from available assets in determining whether certain "non-funding" limits are met, such as those triggering benefit cut-offs and "at risk" status. This can force a waiver of a large part of a company's existing credit balance, undermining prior pre-payments made in good faith and discouraging pre-funding in the future. It is vital that this result be corrected.

- **<u>Deductible Contributions:</u>** Plan sponsors face various limitations on the contributions they can make to their plans on a tax-deductible basis. While the Administration provided some relief in this area, the approach in H.R.2830 is more complete and more useful to plan sponsors. The bill both allows deductions of contributions up to 150% of current liability and also of contributions, under certain circumstances, in excess of 25% of compensation. This latter provision is particularly important for so-called "legacy" plans where there can be far more retirees than workers and the 25% of compensation limit will severely limit the ability of the employer to fund the plan. ERIC also recommends that the 10% excise tax imposed on non-deductible contributions be abolished.

<u>IMPORTANT ACTIONS:</u>
H.R.2830 proposes additional reforms that Congress should enact.

- **<u>Permanent Interest Rate:</u>** H.R.2830 establishes a permanent interest rate for calculating liabilities. Few circumstances have caused more confusion and created a greater impediment to employers maintaining defined benefit plans than the absence of a permanent discount rate since 2001.

- **<u>Coordination of Lump Sum Calculations:</u>** The bill coordinates the discount rate used for funding with that used to calculate minimum lump sum distributions, with a phase-in to prevent disruption of individuals' retirement planning. This is a critical step that will ensure that plans with lump sums are not stripped of assets when large numbers of employees leave at once. The bill, however, should be amended to provide for plans that, under current law, rely on rates other than the 30-year bond rate for the calculation of lump sums.

- **<u>Phase-in of Premium Increases:</u>** The bill contains substantial increases in premium-taxes paid to the PBGC. To ameliorate the impact of this change, H.R.2830 phases those increases in over time. (Note below, however, that ERIC strongly opposes indexing of premiums in the future.)

<u>AREAS FOR ADDITIONAL ANALYSIS AND AREAS OF CONCERN:</u>
H.R. 2830 proposes a substantially new framework for funding requirements. This scheme must be carefully examined by real companies with real plans in order to ensure that it results in more soundly financed plans in both the short and the long term while making it possible – even inviting – for employers to maintain their defined benefit plans and establish new ones. This examination cannot be completed in less than one week. Nevertheless, we offer the following by way of a preliminary analysis to guide the Committee's further deliberations even as we continue our examination of the bill's provisions.

- **Long-Term Funding Rules:** Sponsoring a defined benefit pension plan is not a one-year, three-year, or even five-year commitment. It is a commitment that spans several decades. We are concerned that H.R.2830 repeals the long-term funding rules that form the bedrock of ERISA, under which plans experienced real growth and expansion, and which for decades have resulted in the vast majority of plans being well-funded and paying all promised benefits to participants. Maintaining the long-term perspective is vital in meeting the goal of encouraging employers to establish and maintain defined benefit plans and to providing a sound, predictable, and stable funding basis for companies sponsoring pension plans. We are concerned that repeal of these rules – and reliance solely on the short-term focus taken by H.R.2830 – is likely to result in fewer plans and less well funded plans over time.

- **Volatility & Harshness:** The present current liability funding rules have already introduced significant volatility into funding and can confront sponsors with funding requirements that are sudden and harsh, which makes defined benefit plans less attractive for businesses and, during the recent downturn precipitated the freezing of benefits in numerous plans. H.R.2830 appears to add significantly to the volatility and harshness of current law and to loop into this unfortunate circumstance plans that are actually very well funded. Additional volatility and harshness is caused by: (1) reducing the averaging and smoothing periods to three years; (2) reducing the corridor for valuing assets; (3) establishing a modified yield curve as the discount rate (where fluctuations in the rate and in the curve both affect sponsors liability calculations); (4) dividing the yield curve into three "buckets" each of which can fluctuate; (5) one-sided amortization (in which experience losses increases amounts to be amortized but the largest amortization amount is carried forward in spite of experience gains until the plan regains a 100% funded level; and (6) the 100% funding target itself. While the bill's four-month "lookback" in setting the plan's discount rate is helpful, we are very carefully examining whether its seven-year amortization period will work in the context of cyclical companies and we are very concerned that the bill's provisions appear to come down hard on plans that are extremely well funded – i.e. close to 100% funded – and are of no threat to the PBGC. ERIC has proposed a 90% threshold for accelerated funding. In setting an appropriate target, it is appropriate to remember that a 10-15% swing in the funded ratio of a plan is a <u>normal</u> result of economic ups and downs. If the threshold is set too high, then plans will be significantly overfunded at the top of the economic cycle, but will be provided no leeway for ordinary and normal downswings. The unnecessary pressure on a company's cash makes it less likely the company will maintain a defined benefit plan, defeating the purpose of the legislation.

- **Yield Curve:** H.R.2830 contains a modified yield curve designed to ameliorate problems stemming from the yield curve set out in the Administration's proposals. Unfortunately it does not achieve that goal and we remain convinced that adopting a yield curve for pension funding purposes is a mistake. If the Congress believes it is important to have different rates for mature and young plans, there are much simpler ways to accomplish that goal, and we would be pleased to discuss this further with the Committee. Some of our concerns include: (1) The modified yield curve does not simplify required calculations since each plan must still make estimates of future payouts for years into the future. (2) The underlying yield curve rate is only tangentially market-based and it is extremely opaque. A yield curve works well for financial instruments, such as mortgages or Treasury bonds, where the structure of the bonds is similar and the payout set. But the corporate bond market is very diverse – and future pension payouts are only guesses. They are not set. Moreover, at the durations that are most important for pension plans, the bond market often is thin or non-existent. So the Administration's yield curve actually is a fabrication constructed by agency officials. At best there will be errors in judgment. At worst the discount rate that must be used for a $2 trillion program is subject to manipulation that will be impossible for Congress to uncover. These problems are actually exacerbated by the vagueness in H.R.2830 where the Treasury apparently would have leeway to set rates anywhere within the three segments. (3) Use of a Treasury-constructed yield curve obliterates companies' ability to predict future contributions. (4) Use of a yield curve, even a modified one, adds to the volatility of required contributions since both the interest rate and the slope of the curve will move.

- **Mortality Assumptions:** While ERIC recognizes the RP2000 mortality table as published by the Society of Actuaries as a carefully constructed table that relies on data derived from existing pension plans, we are concerned that H.R.2830 requires use of discounts rates that are designed to reflect more precisely than current law the maturity of plan liabilities – but fails to allow similar precision regarding mortality assumptions. This will result in a mis-match of assumptions and severe inaccuracies in measuring liabilities for many plans. ERIC has proposed that plan-specific mortality assumptions be allowed, and the bill should be amended to make this possible.

- **Effective Date:** The bill assumes that plans can prepare for a significantly new funding scheme by 2006. This is simply unrealistic. Imposing changes of this magnitude that quickly is likely to result in chaos, followed by significant numbers of plans being terminated or frozen.

- **Indexing of premiums**: While ERIC recognizes that some increase in PBGC premiums is likely, we very strongly oppose indexing of the premiums in the future. This has the effect of increasing premiums on all plan sponsors regardless of whether the agency needs the money or not and in direct violation of the mandate contained in ERISA (sec. 4002) that premiums be kept at the lowest possible level. This is so that available money can go into the plan – not be diverted unnecessarily to a government agency. The result can only be that plans will become more unattractive to maintain over time. Moreover, under the bill, the variable rate premium would be indexed twice. Since it is expressed as percent (0.9%) of underfunding, the variable rate is automatically indexed as the value of wages and benefits increase over time. The bill would impose a second wage index on top of the one already imbedded in the rate's structure. If Congress deems a premium increase is necessary, we urge that it provide plan sponsors the certainty of knowing what that increase is by setting out the amounts required in the law.

- **Benefit Cut-offs:** It is important to maintain benefits for participants in all cases where that is possible. H.R.2830, like the Administration proposal, focuses on the PBGC and not on the participants and, in so doing, eliminates or reduced benefits in ways that are counterproductive and completely unnecessary. ERIC has proposed a comprehensive set of measures that would protect both participants and the PBGC and we strongly urge that the bill be modified in line with those proposals. ERIC's proposals are appended to this testimony.

- **Disclosure:** The bill contains several new disclosure provisions. ERIC proposes an approach that is simpler, faster, and more relevant. We propose that the information prepared for a company's 10-K be provided, on a plan-by-plan basis, to plan participants. This means that every year participants will be getting the same information as investors – and they will be getting it 60 days after the close of the year (90 days for smaller companies).

CONCLUSION:

ERIC is prepared to work with the Committee toward its goals – sound funding of defined benefit pension plans and an environment where employers face legal certainty regarding their plans and where they will want to establish and maintain these valuable retirement security programs.

ADDENDUM #1
ADDITIONAL ISSUES REGARDING H.R.2831

The following provisions should be included in H.R. 2831:

1. **Amendments to Anti-backloading Rules.** Legislation should amend the anti-backloading rules, both prospectively and retroactively, to provide that if a plan provides participants with the benefit produced by two or more alternative formulas, the plan will comply with the anti-backloading rules if each of the formulas, tested separately, complies with those rules.
   A. This allows an employer that converts its traditional defined benefit plan to a hybrid formula to offer generous transition benefits to affected plan participants.

2. **Offset for Benefits Provided by Another Plan.** The legislation should also clarify, both prospectively and retroactively, that if a plan provides for an offset for benefits provided by another plan, the plan will comply with the anti-backloading rules if the gross benefit formula (i.e., before application of the offset) complies with the anti-backloading rules.
   A. In the case of a floor-offset arrangement involving a defined benefit plan and a defined contribution plan, where the benefits under the defined benefit plan are offset by the actuarial equivalent of the benefits under the defined contribution plan, the defined benefit plan complies with the anti-backloading rules if its gross benefit formula (i.e., before application of the offset) complies with the anti-backloading rules.

3. **Nondiscrimination Rules.** The legislative history should direct the Treasury not to revisit the nondiscrimination testing issue raised by the proposed Internal Revenue Code sec. 401(a)(4) regulations that the Treasury has withdrawn.
   A. Because hybrid plans are defined benefit plans, it should always be permissible to test them as defined benefit plans under sec. 401(a)(4) as well as to cross-test them as defined contribution plans.

4. **Determination Letters.** The legislative history should direct the Treasury to begin issuing, by a date certain, determination letters to plans that have been converted from traditional designs to hybrid designs.

ADDENDUM #2
PROPOSED RESTRICTIONS ON BENEFIT IMPROVEMENTS AND PAYOUTS

1. Treat shut-down benefits as a plan amendment for funding and guarantee purposes as of the date they are triggered. Also apply to shut-down benefit payments the restrictions under present law and proposed below that apply to payment of lump sums.

The Administration's proposal would needlessly jeopardize benefits that are vital to workers, especially older workers, whose place of employment is being shut down. While it is true that under the current structure the PBGC's liability can be increased for shut down benefits for which no funding has been allowed under current law, the solution is not to abolish the benefits in all instances – including in ongoing, well-funded, and even over-funded plans that can easily afford them. The solution is to adjust the funding and guaranty rules to protect the PBGC from sudden increases in its liability.

Shut down and other contingent benefits typically cannot be funded until they are triggered by the contingent event. This makes sense because the triggering of such benefits is nearly impossible to predict on a reliable basis. On the other hand, under present law, shut-down benefits are guaranteed by the PBGC. For shut downs that occur just before an underfunded plan terminates the PBGC must assume a liability for which there has been no opportunity for funding to occur.

Most shut down benefits are paid without imposing any liability whatsoever on the PBGC. They are paid from an ongoing plan that is not terminating or from a plan that is terminating but is well- or over-funded. Thus, if shut-down benefits are treated as a plan amendment for both funding and PBGC guarantee purposes, the PBGC's exposure is contained while preserving the payment of shut down benefits in the vast majority of circumstances. Moreover, such treatment would be consistent with other types of benefits that accrue shortly before termination but were previously unknown (i.e., plan amendments).

As an additional measure of protection, the same restrictions could be placed on payment of shut down benefits as are proposed below regarding payment of lump sum benefits.

2. Freeze the benefit the PBGC will guarantee at the time of bankruptcy.

Bankruptcy proceedings can stretch out over a long period of time. We agree with the Administration that the PBGC guarantee limit should be frozen for a plan at the time of the bankruptcy filing.

3. Prohibit amendments that increase benefits if the plan is less than 70% funded and has been less than 100% funded for more than a year.

Under current law, amendments that increase benefits are prohibited if they would reduce the plan's funded status below 60% unless simultaneous action is taken to restore the plan at least to a 60% funded level. The Administration proposes to raise this bar to 80%. This is simply too high. As we noted earlier, only 3.3% of the dollar amount of all claims received by the PBGC from 1975 through 2003 came from plans that were funded at a 75% or higher level on a termination basis. Plans that are reasonably well funded simply are not a threat to the PBGC and should be allowed to operate without government interference. Moreover, we have proposed that the amortization period for plan amendments that increase benefits be reduced from 30 to 10 years, a very significant change that will ensure that funding for plan amendments is significantly accelerated.

On the other hand, a plan that is 60% funded can present a significant exposure to the PBGC. Thus we propose that the 60% level be increased to 70%.

4. If the plan sponsor is in bankruptcy, limit the percentage of any lump sum that can be paid to the plan's funded status.

The Administration has proposed to prohibit payment of lump sums under a variety of circumstances in an apparent effort to curb the depletion of assets in a plan that might be transferred to the PBGC. Unfortunately, the PBGC's proposal is far too broad, sweeps into its net too many plans that will not be transferred to the PBGC, and thus will cause serious and completely unnecessary disruption for older workers who are nearing retirement and have little chance to rearrange their plans. Moreover, the PBGC's abrupt approach is likely to trigger the very "run on the bank" it seeks to avoid as workers eligible to take a lump sum will do so prematurely rather than risk losing it later.

A less disruptive approach that still protects the PBGC would be to apply restrictions only if the plan sponsor is in bankruptcy and, in these circumstances, to limit the percentage of a lump sum that can be paid to an individual to the plan's funded status. In other words, if the employer is in bankruptcy and the plan is 80% funded, then eligible individuals could receive 80% of their benefit in the form of a lump sum.

5. Retain present law prohibitions on benefit amendments in bankruptcy as well as present law prohibitions on lump sum and other accelerated forms of benefit payments in the case of a plan with a liquidity shortfall.

Bankruptcies can take several years to work through, and key to the employer's ability to turn the business around is its ability to retain knowledgeable and skilled employees. The Administration proposes to freeze the company's pension plan at the start of a bankruptcy, even if the plan is 99% funded. This hammer-blow approach will, in fact, harm rather than protect the PBGC by making it far more likely the company will not be able to retain the key employees it needs to effect a recovery.

Under present law, if the employer maintaining a plan is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan – including by an increase in benefits or any change in the accrual of benefits or in the rate at which benefits vest under the plan. Plans that have assets equal to less than three years of benefit payments may not make lump sum payments or other payments that deplete assets on an accelerated basis. These provisions of law should be retained.