CHALLENGES FACING PENSION PLAN FUNDING

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
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CHALLENGES FACING PENSION PLAN FUNDING

WEDNESDAY, APRIL 30, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:36 p.m., in room 1100, Longworth House Office Building, Hon. Jim McCrery (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 226–5911
April 23, 2003
No. SRM–1

McCrery Announces Hearing on Challenges Facing Pension Plan Funding

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on challenges facing pension plan funding. **The hearing will take place on Wednesday, April 30, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:30 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Under present law, pension plans are required to use the 30-year Treasury bond rate for a variety of defined benefit pension calculations. For example, the 30-year Treasury rate is used to calculate funding requirements, certain premium payments to the Pension Benefit Guaranty Corporation (PBGC), and lump sum distributions.

As a result of the U.S. Department of the Treasury's debt buyback program and the subsequent discontinuation of the 30-year Treasury bond, the interest rate on outstanding 30-year bonds has fallen significantly. Businesses have expressed concerns that this very low rate results in an overstatement of their actual liabilities, thus forcing them to make artificially inflated payments to their pension plans and to the PBGC.

In 2002, the Congress enacted temporary relief in the *Job Creation and Worker Assistance Act* (P.L. 107–147). The new law temporarily raises the permissible interest rate which may be used to calculate a plan's current liability and variable rate PBGC premiums. The provision applies to plan years 2002 and 2003. This hearing will explore options for a permanent and comprehensive replacement solution. The hearing will also explore other pension plan funding issues that have been raised.

In announcing the hearing, Chairman McCrery stated, "The issue of pension funding is a perilous one. Funding requirements which are too low will leave plans drowning in liability and unable to pay promised benefits. Funding requirements which are too high will burden companies by forcing them to shore up a plan by devoting resources which are more urgently needed for current expenses, such as new employees or buying new equipment. The challenge for Congress is both clear and daunting."

FOCUS OF THE HEARING:

The focus of the hearing is to discuss the funding rules related to defined benefit pension plans and evaluate proposals for replacing the 30-year Treasury rate that is used in pension plans calculations.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Wednesday, May 14, 2003. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman MCCRERY. The hearing will come to order. Good afternoon, everyone. As you are now hearing, we have votes on the House floor, a series of votes. What we will do is, I and my Ranking Member, Mr. McNulty, will deliver our opening statements and then probably recess to go vote and come back.

Today the Subcommittee will examine issues regarding the funding of defined benefit (DB) pension plans. In particular we will focus on proposals to replace the 30-year Treasury bond rate which is used by plan sponsors to calculate how much cash they must contribute to their pension plans and the size of lump sum distributions paid to retirees from those plans.

Pension plans must use specific interest rate assumptions in calculating whether the plan meets various funding requirements. In 1987, the Congress chose a 4-year weighted average of the 30-year Treasury rate as a benchmark. Until recently, plans could use any interest rate between 90 percent and 105 percent of that weighted average.

The Treasury rate was chosen because it was deemed to be transparent, difficult to manipulate, and a fair proxy for the price an insurer would charge for a group annuity which would cover accrued benefits if the plan would be terminated.

Artificially high interest rates may lead companies to underfund a pension plan today, possibly leading to future shortfalls. Likewise, artificially low interest rates may force companies to overfund a DB plan relative to its future needs. In an economic slowdown, this can further weaken cash-strapped companies, forcing them to make required contributions instead of using the money to retain current employees, hire new ones, or invest in new equipment.

In 2001, the U.S. Department of Treasury discontinued issuing 30-year bonds. Combined with other market forces, the interest rate on the outstanding bonds has fallen significantly. According to a recent report by the U.S. General Accounting Office the rate has diverged from other long-term interest rates, an indication that it also may have diverged from group annuity rates.

Responding to this situation in 2002, the U.S. Congress included a provision in the Job Creation and Worker Assistance Act which temporarily allowed plans to use an interest rate as high as 120 percent of the 30-year Treasury rate to determine plan funding requirements. Not only does the provision expire at the end of this year, it also avoided one of the most vexing issues which Congress must face in considering a replacement rate. That is, the subject of lump sum distributions. When an individual becomes eligible for benefits from a DB plan, he may have the choice to take those benefits on a monthly basis over his lifetime or to receive them as a lump sum. The lump sum should equal the present value of the lifetime annuity. The 30-year Treasury rate is used to make this calculation.

If the 30-year Treasury rate is much lower than the rate earned on an actual annuity, then the lump sum payment will be artificially high. By contrast, if the 30-year Treasury is much higher than the rate earned on an actual annuity, then the lump sum payment will be artificially low. As a result, using an inaccurate rate to calculate lump sums could create significant distortions in a retiree's choice between annuities and lump sum distributions.

The temporary relief passed in 2002 did not address this issue, leaving unchanged the range of interest rates which can be used in calculating lump sum distributions. I look forward to hearing testimony today about this issue.

We may also hear today about current rules which limit contributions by employers when a plan is overfunded. Designed to prevent companies from taking excessive deductions, these rules could have the perverse effect of discouraging companies from setting aside money for a DB plan when times are good, expecting them instead to be able to free up the necessary cash when times are bad. I am interested in considering whether the well-intended deduction limits in current law are really serving the best interests of employees and retirees.

I am also interested in hearing about the effect of the funding rules on the current financial status of the Pension Benefit Guaranty Corp. (PBGC), which steps in and assumes the liabilities for plans no longer able to meet their DB commitments.

Increasing the interest rate used in calculating future liabilities would have cross-cutting effects on the PBGC. On one hand, such a move would reduce the number of employers paying variable rate premiums to the PBGC and might give a clean bill of health to some financially troubled plans. On the other hand, ensuring funding requirements are consistent with real-world interest rates would reduce the financial stress on employers and could keep some of them from having to turn over their plans to the PBGC.

With the economy still sputtering and the prospect of PBGC having to assume the liabilities of additional pension plans still looming, this is an important issue which merits consideration today.

Before we get to those discussions, we will hear from Peter Fisher from the Department of Treasury to give the administration's perspective. Before we can hear from him, I want to yield to my friend and colleague from New York, Mr. McNulty, for any opening comments he would like to make.

[The opening statement of Chairman McCrery follows:]

Opening Statement of The Honorable Jim McCrery, Chairman, and a Representative in Congress from the State of Louisiana

The hearing will come to order. I ask our guests to please take their seats.

Good afternoon.

As this is our first hearing of the year, let me again welcome to the Subcommittee on Select Revenue Measures our newest Members, Mac Collins, Max Sandlin, Lloyd Doggett, and Stephanie Tubbs-Jones. I am sure they will each add their own unique perspectives to our work.

Today, the Subcommittee will examine issues regarding the funding of defined benefit pension plans. In particular, we will focus on proposals to replace the 30-year Treasury bond rate, which is used by plan sponsors to calculate how much cash they must contribute to their pension plans and the size of lump sum distributions paid to retirees from those plans.

Pension plans must use specific interest rate assumptions in calculating whether the plan meets various funding requirements. In 1987, the Congress chose a four-year weighted average of the 30-year Treasury rate as a benchmark. Until recently, plans could use any interest rate between 90% and 105% of that weighted average.

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Artificially high interest rates may lead companies to under-fund a pension plan today, possibly leading to future shortfalls. Likewise, artificially low interest rates may force companies to over-fund a defined benefit plan relative to its future needs. In an economic slowdown, this can further weaken cash-strapped companies, forcing them to make required contributions instead of using the money to retain current employees, hire new ones, or invest in new equipment.

In 2001, the Treasury Department discontinued issuing 30-year bonds. Combined with other market forces, the interest rate on the outstanding bonds has fallen significantly. According to a recent report by the General Accounting Office, the rate has "diverged from other long-term interest rates, an indication that it also may have diverged from group annuity rates."

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When an individual becomes eligible for benefits from a defined benefit plan, they may have the choice to take those benefits on a monthly basis over their lifetimes or to receive them as a lump sum. The lump sum should equal the present value of the lifetime annuity. The 30-year Treasury rate is used to make this calculation.

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Before we get to those discussions, we will hear from Peter Fisher from the Treasury Department to give the Administration's perspective.

And before we can hear from him, I yield to my friend and colleague from New York, Mr. McNulty, for any opening comments he would like to make.

Mr. MCNULTY. Thank you very much, Mr. Chairman. In the interest of time I will just submit my written statement for the record, because you have adequately outlined the issues at hand. I will just say two things. Number one, thank you for accommodating my schedule, because this hearing was originally scheduled at a time I would not be able to make it, and I thank you for changing that so that I could be here today. Number two, thank you for scheduling the hearing, because these issues are of critical importance to the future retirement security of millions of American workers.

[The opening statement of Mr. McNulty follows:]

Opening Statement of The Honorable Michael R. McNulty, a Representative in Congress from the State of New York

I am pleased to join Chairman McCrery and the Select Revenue Measures Subcommittee for this hearing today to consider issues which are crucial to the continued retirement security for millions of our workers.

An important aspect of the current pension system is our defined benefit (or DB) plans. These plans provide a secured source of retirement income for those workers who are eligible to participate.

In recent years we have seen some of the major weaknesses of our defined contribution (or DC) plan system. The failure of major corporations such as Enron and Worldcom has had a devastating impact on workers' retirement whose assets were held in a 401(k) plan. In addition, we have witnessed the impact of the weak stock market on the money available to workers under their retirement plans. These account balances have decreased substantially over the past two years.

Under DB plans, workers do not bear these risks. These investment risks remain with the plan and the employer. The worker is guaranteed the promised pension benefit under the plan.

This hearing today gives us the opportunity to examine the impact of the 30-year treasury bond rate on the funding of DB plans.

The Department of Treasury's debt buyback program, and its subsequent announcement to discontinue issuing 30-year Treasury bonds, have impacted the interest rate of the outstanding bonds as the rate steadily declines. Sponsors of DB plans have expressed concerns regarding the increased funding obligations for these plans because of the declining 30-year interest rate.

As the baby-boom generation prepares to retire, beginning as early as 2008, every aspect of retirement becomes important, including the issue before us today.

I thank Chairman McCrery for scheduling this important hearing, and I thank our guests for appearing before us to testify. We look forward to working together with the Administration and all interested parties to resolve this issue.

Chairman MCCRERY. Thank you, Mr. McNulty. I was more than happy to accommodate your request because this is a problem that is going to require joint effort to solve, I think. So, we were pleased to be able to do that so you could be here and contribute to our attempts to understand this problem and I hope, solve it.

With that, I will call the first panel, the Honorable Peter Fisher, Under Secretary for Domestic Finance, Department of Treasury; and Steven A. Kandarian, Executive Director of the PBGC. Gentlemen, welcome. Rather than have you begin and have to be interrupted, I am going to ask you to withhold and then we will recess until right after the final vote. It is a series of votes, I don't know if it is two or three. Series of four votes. So, it will probably be, unfortunately, about one-half hour before we get back. We will get back as soon as we can. The hearing is in recess.

[Recess.]

Chairman MCCRERY. The hearing will come to order. Gentlemen, we apologize for the delay. Now we will be pleased to hear your oral testimony. I know that your written testimony will be entered into the record in its entirety. Now, Mr. Fisher, if you would summarize your testimony in about 5 minutes, and we would appreciate that.

STATEMENT OF THE HONORABLE PETER R. FISHER, UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Mr. Chairman, Ranking Member McNulty, other Members of the Committee, thank you for this opportunity to discuss the need to strengthen Americans' retirement security by measuring pension liabilities accurately.

There is a pension funding problem in America today. Pension plan participants are uncertain about their plans' funding levels. Equity markets are unsure of the demands that minimum pension funding may impose on sponsors' cash flows. Without an accurate measure of liabilities, the minimum funding rules could lead to insufficient or excessive funding of pension promises, as you, Mr. Chairman, pointed out in your opening remarks.

We must remember that behind all the technical details is the retirement security of hardworking Americans. Our ultimate goal must be to improve pension security for workers and retirees by strengthening the financial health of the voluntary DB pension system. Pensions must be well funded for the benefit of workers and retirees. Plan sponsors must be able and willing to support the DB system. The PBGC's financial integrity must be assured. All three groups have an interest in a sustainable program and in the right solution, and any changes we undertake must promote the resiliency of our financial system.

H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, recognizes the urgency of pension reform and promoting retirement security. Its chief sponsors, Congressmen Portman and Cardin, are to be commended for their leadership.

H.R. 1000, the Pension Security Act of 2003 introduced by Representative Boehner, advances principles for improving the DB contribution system that the President set forth last year. My testimony today will focus only on measuring pension liabilities.

In our view, overall pension reform requires three steps: first, develop a more accurate, reliable and timely measure of pension liabilities; second, fix the pension funding rules; and third, establish transition rules so as to avoid an abrupt change in firms' funding plans.

Current law uses the 30-year Treasury rate for measuring pension liabilities. Because of our discontinuation of the 30-year bond and the shortened time structure of payments in many pension plans and other changes in financial markets, the Department of Treasury does not believe that the 30-year Treasury rate produces an accurate measure of pension liabilities.

As you pointed out, Mr. Chairman, last year Congress responded to Federal employees' concerns with a temporary extension and expansion of the upper range of the allowable corridor surrounding the 30-year Treasury rate for calculating current liability. This expansion expires at the end of this year. Without further action, the upper end of the corridor will snap back to 105 percent, distorting both the measurement of current liabilities and funding requirements.

Ideally, Congress would develop an appropriate permanent replacement for the 30-year Treasury rate. H.R. 1776 offers a permanent replacement based upon long-term, high-quality corporate bond rates. We believe that moving from a Treasury full faith and credit discount rate to one based on rates on high-quality, long-term corporate bonds could improve the measurement accuracy.

Before Congress selects any permanent replacement for the 30-year, it will be necessary to consider at least three key issues. First, different pension plans have different benefit payment schedules, some with quite immediate payment requirements and others whose expected payments are in the distant future. In principle, pension liabilities could be more accurately measured if the discount rates were related to the time structure of benefit payments. We suggest that it is important to consider whether and how to reflect the time structure of a pension plan's future benefit payments in the discount methodology.

Second, under current law, the measurement of both assets and liabilities involve "smoothing" techniques, as do the funding requirements. While there may be sound reasons to measure current interest rates using something other than the spot rates on a particular trading day, the current practice of using a 4-year average raises important questions as to the accuracy of the resulting measure. We need to review carefully whether this practice continues to make sense.

Third, under current law, as you again described, Mr. Chairman, pension liabilities are calculated using one discount rate but lump sum payments are calculated using a different discount rate. We suggest considering whether and how a permanent replacement for the 30-year Treasury rate should affect the discount rate for lump sum payments. The consequence of failing to settle on an appropriate discount rate methodology will be an inaccurate measurement of pension liabilities. That means under- or over-funding of pension plans, either less secure pensions for workers and retirees or undue burdens on plan sponsors. Further work is needed to define an accurate measurement before we settle on a permanent solution.

So, what should we do now? We recommend that Congress enact legislation before the end of June to extend the corridor relief that Congress provided in 2002. We propose that for plan years beginning in 2004 and 2005, the upper bound of the interest rate corridor continue to be 120 percent of the 4-year weighted average of the yield on the 30-year Treasury security. Quick action on this temporary extension is critical.

At the same time, we need to act swiftly to devise a permanent solution, not just for the liability measurement, but funding and transition rules too. The PBGC's Executive Director, Steve Kandarian, will illustrate the urgency of the work before us. We look forward to working with you on both an interim and then a permanent solution. Thank you.

[The prepared statement of Mr. Fisher follows:]

Statement of The Honorable Peter R. Fisher, Undersecretary for Domestic Finance, U.S. Department of the Treasury

Chairman MCCRERY., Ranking Member McNulty, and members of the Committee, I appreciate this opportunity to discuss with you the need to strengthen Americans' retirement security by measuring accurately pension liabilities.

There is a pension funding problem in America today. Wall Street firms estimate that current pension underfunding runs to hundreds of billions of dollars. Pension plan participants are uncertain about their plans' funding levels and equity markets are unsure of the demands that minimum pension funding may impose on sponsors' cash flows. The absence of a clear picture of the extent of defined benefit pension underfunding creates a cloud of uncertainty in equity markets. Moreover, without an accurate measure of liabilities, the minimum funding rules, which rely upon an accurate measurement of pension liabilities, could lead to insufficient (or excessive) funding of pension promises.

To deal with this challenge, an important step is to develop a more accurate, reliable, and timely measure of pension liabilities.

As we go about this task, we must remember that behind all the technical details we will discuss is the retirement security of hardworking Americans. Our ultimate goal must be to improve pension security for workers and retirees by strengthening the financial health of the voluntary defined benefit pension system that they rely upon. That system is complex, with many interdependent parts. Achieving our objective of secure pensions requires that those pensions be well-funded, that plan sponsors be able and willing to support the defined benefit system, and that the Pension Benefit Guaranty Corporation's financial integrity be assured. All three of these groups have an interest in a sustainable program, so all have an interest in getting to the right solution. In addition, any changes we undertake need to be implemented in a manner that promotes the stability and resiliency of our financial system and financial markets.

Before proceeding, let me first note that H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, recognizes the urgency of pension reform and of promoting retirement security. Its chief sponsors, Congressmen Portman and Cardin, are to be commended for their leadership in this complex, but critical area of public policy. I would also note that H.R. 1000, the Pension Security Act of 2003, introduced by Rep. Boehner advances principles for improving the defined contribution system that the President set forth last year. My testimony, however, will focus just on the issue of measuring pension liabilities.

In our view, overall pension reform that will lead to more secure pensions for American workers and retirees requires three steps: first, develop a more accurate, reliable, and timely measure of pension liabilities; second, fix the pension funding rules; and third, establish transition rules so as to avoid an abrupt change in firms' funding plans.

The predicate step to making pensions more secure is to develop a more precise measurement of pension liabilities. My testimony today will focus on this critical step and, in particular, on the issue of replacing the 30-year Treasury rate as the discount rate used in measuring pension liabilities. As I will explain, it is critical that Congress develop an appropriate, permanent replacement for the 30-year Treasury rate in measuring pension liabilities. However, there are many critical questions that need to be answered before settling upon that replacement. Thus, to give firms the certainty they need to plan for their short-term pension funding obligations, we recommend extending the current temporary corridor for two more years. At the same time, we need to begin work immediately on getting to that permanent replacement and to dealing with other problems with the current system.

Discounting Future Pension Benefit Payments to Today's Dollars

Making pensions more secure requires a more precise measurement of pension liabilities. The amount of pension liabilities determines a plan sponsor's annual funding obligation. Without a reliable measure of pension liabilities, plan sponsors may not contribute sufficient funds to their pension plan—or may contribute more than they need to for the obligations undertaken.

In addition, without accurate, reliable measures neither plan beneficiaries, investors, nor the Pension Benefit Guaranty Corporation know how big the pension obligation may be for a given firm. Investors that do not have a clear picture of a company's pension liabilities factor that uncertainty into their credit evaluation of the firm, raising its borrowing costs and lowering its stock price.

In order to get to a more accurate measure of pension liabilities, we need to agree on how to discount future benefit payments to today's dollars. After describing why this is so, I will then describe why we believe that we should be working towards a permanent replacement for the 30-year Treasury rate in measuring pension liabilities.

Using a Discount Rate to Measure Pension Liabilities

Pension liabilities are measured as the discounted present value of the future benefit payments to be made to a pension plan's participants. These future benefit payments depend upon numerous factors, including the terms of the particular plan and actuarial and mortality assumptions about plan participants.

To get the present value—that is, the cost in today's dollars of these future payments—these future payments must be "discounted" by some interest rate to show how many dollars today are equivalent to those payments in the future. As the interest rate that is used to discount future benefit payments declines, the value of those liabilities increases.

A simple example explains this concept. Suppose someone was offered the choice between $100 today and $110 a year from now. If that person could invest $100 today at a 10 percent annual return, the two offers would have the same economic value. If however, interest rates were lower and the person could only earn 5 percent annually, the offers would not have the same economic value. Instead, the person would need to be offered $104.76 today for the offers to be economically equivalent. Thus as interest rates decline, the amount of money a pension plan needs today (to have in discounted present value terms the amount of money needed to make future benefit payments) increases.

Background on the Use of the 30-Year Treasury Rate

Federal law sets minimum funding rules for private pension plans. These rules reflect the complex actuarial work needed to determine the amount of assets that a plan should hold to meet its benefit obligations many years into the future. One of the most important of these rules is the interest rate for discounting pension liabilities. Since 1987, the law has used the yield on 30-year Treasury bonds as the basis for this interest rate. The measurement of a pension plan's liabilities calculated using this rate is the basis for the federal "backstop" funding rules applied to underfunded pension plans.

Congress chose the 30-year Treasury rate as an approximation of interest rates used in the group annuity market. In other words, Congress wanted a discount rate that would reflect how much an insurance company would charge a pension plan to assume responsibility for the plan's benefit obligations.

Although additional refinements have occurred since 1987, the rate on the 30-year Treasury bond continues to play a prominent role in determining pension liabilities for funding purposes. Until recently, pension plans could determine the value of their pension liabilities using any rate between 90 percent and 105 percent of the four-year moving average of the yield on 30-year Treasury bonds. As I will explain shortly, last year, Congress temporarily increased the upper end of this corridor to 120 percent. Note that the upper end of the corridor produces a larger discount rate and hence a smaller measured liability and a smaller funding requirement. The lower end of the corridor produces the reverse—a larger measured liability and hence greater required funding.

However, the Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities.

Why We Need to Replace the 30-Year Rate in Measuring Pension Liabilities

The discontinuation of the issuance of the 30-Year bond—which was part of much needed changes in Treasury financing of government debt—makes replacement of the 30-year rate in pension law necessary. However, we believe that regardless of whether the discontinuation had occurred or not, there was already growing evidence and concern that the 30-year Treasury was becoming less relevant as a benchmark for use in pension calculations.

One reason the 30-year Treasury has become less relevant is because of changes in pensions themselves. The lengthy time structure of the 30-year bond makes it less and less relevant when compared to the shortening time structure of the payments of many defined benefit pension plans. This shortened time structure is the consequence of the increasing average age of active and terminated deferred participants and the increased proportion of participants represented by retirees. Using a long-term rate to discount all pension obligations understates the true cost of obligations that will be paid sooner whenever the yield curve is upward sloping (as is true now and is generally the case).

In addition, changes in the Treasury bond market and in financial markets more broadly have made the 30-year Treasury rate less reflective of the cost of group annuities and less accurate as a benchmark for pension liabilities. The difference between the Treasury yield curve and a high-grade corporate bond curve is not fixed, and that spread is wider today than it was in 1987.

In response to these concerns, last year Congress provided for a temporary expansion of the upper range of the allowable corridor surrounding the 30-year Treasury for calculating the interest rate used to determine current liability. This temporary change expires at the end of this year. In the absence of a permanent replacement or an extension of last year's expansion of the upper range, the law will "snap back" to 105 percent as the upper end of the corridor.

Such an outcome would, in our view, increase the discrepancy between the discount rate mandated in the law and that used to price group annuities. And since minimum funding rules are based upon measured (current) liabilities, a discount rate that further distorts that measurement will also distort the funding requirements.

Consequently, we believe that Congress should take action this year to avoid this "snap back." And, since firms need to make plans now for the funding contributions they will make next year, we believe that Congress needs to act quickly on this matter.

Finding a Permanent Replacement for the 30-year Treasury Rate

We need to get to a permanent replacement for the 30-year Treasury rate in computing pension liabilities.

H.R. 1776 offers a permanent replacement for the 30-year Treasury with a measure based upon long-term high-quality corporate bond rates. We believe that moving from a Treasury full faith and credit discount rate to one based on rates on high-quality long-term corporate bonds could improve the accuracy of measuring pension liabilities. Pension benefit promises made by private sponsors are not without risk since pension sponsors can and do go out of business. We think that this risk should be reflected in the computation of pension liabilities. We also understand that high-grade corporate bond rates are used in group annuity pricing.

Before Congress selects any permanent replacement for the 30-year Treasury rate, however, it will be necessary to consider several key issues, including the following.

First, different pension plans have different benefit payment schedules, some with quite immediate payment requirements and others whose expected payments are distant in the future. We know that the yields available on financial instruments are different for these different maturities; typically yields relevant to closer maturities are lower. Thus the question arises whether an accurate present value measurement of these different benefit payments—some made in the near-term and some in the distant future—should be discounted at rates appropriate to their respective timing.

Both economic theory and current practice in fixed-income markets suggest that the most accurate way to measure the present value of a stream of future cash flows is to match the cash flows occurring at a particular time with a discount rate that reflects the interest rate on a portfolio of financial instruments with the same maturity date. In this way, the discount rates used would be reflecting the time structure of the cash flows. In principle, an accurate measurement of pension liabilities, which is the present value of a series of benefit payments to be made over time, could be more accurately measured if the discount rate used was related to the time structure of those benefit payments.

Thus, we suggest it would be important to consider whether and how to reflect the time structure of a pension plan's future benefit payments in determining the appropriate discount rate to use. At the same time, we recognize that reflecting the time structure of future benefit payments could introduce some added complexity, which would also need to be considered.

Second, under current law, the measurement of both assets and liabilities involves "smoothing" techniques, as do the funding requirements. Properly measured, pension liabilities are the cost in today's prices of meeting a pension plan's future obligations. If a pension plan's obligations were to be settled today in the group annuity market, their value would be determined using today's interest rates rather than an average of rates over the past several years, which is the current practice in measuring current liabilities for minimum funding purposes.

Using current, unsmoothed interest rates would promote transparency. An accountant or analyst evaluating a pension plan can readily determine the funded status of the plan if asset values are expressed at current market prices and liabilities are computed using current unsmoothed discount rates. When either or both of these measures are smoothed, however, it is very difficult to determine the plan's funded status with any degree of certainty. While there may be sound reasons to measure current interest rates for discounting purposes using something other than the spot rates on a particular trading day, the current practice of using a four-year average of interest rates raises important questions as to the accuracy of the resulting liability measurement.

Thus, we suggest that consideration be given to whether continuing this practice advances the ultimate objective. It may be that there are compelling arguments to allow for some smoothing with respect to the funding contributions that plan sponsors make to their pension plans. We need to carefully review whether four-year smoothing of the discount rate used for purposes of measuring a pension plan's liabilities continues to make sense. We also need to consider how eliminating this smoothing could affect the variability of liability measurement, recognizing that under current law the existing use of smoothing still produces volatility in funding requirements.

Third, under current law, pension liabilities are calculated using one discount rate but lump sum payments made by pension plans are calculated using a different discount rate. The pension liability measurement we are discussing is the basis for funding contributions to be made by plan sponsors—some of which will ultimately fund workers' annuity pension payments but some of which will be paid to workers in the form of a lump sum. Thus, we suggest that it would be worth considering whether and how a permanent replacement for the 30-year Treasury rate in measuring pension liabilities should relate to any possible changes in the discount rate used to calculate lump sum payments.

To this point, my remarks have focused on issues to consider in selecting a permanent replacement discount rate for measuring pension liabilities. While these issues are critical to the goal of achieving an accurate measurement of those liabilities, there are additional issues unrelated to the discount rate replacement that should also be considered.

Thus, we suggest that, in the process of working towards a more accurate measurement of pension liabilities, the mortality table and the retirement assumptions that underlie the computation of current liability also be evaluated. There is also the question of whether a sponsor in computing current liability should be allowed to recognize that some retirees opt for lump sums rather than annuities at retirement. Under current law current liability assumes that all retirees take their retirement in the form of an annuity. These questions require further study.

I believe that we all need to consider the issues that I have just described to ensure that any permanent replacement to the 30-year Treasury rate results in an accurate measurement of pension liabilities. The consequence of failing to replace the 30-year Treasury rate with an appropriate discount rate methodology will lead to inaccurate measurement of pension liabilities. Such an outcome, in turn, will lead to under- or over-funding of pension plans. The former outcome would make pensions less secure for workers and retirees. The latter outcome could place an undue burden on plan sponsors by shifting more corporate funds to the pension plan than are necessary to fund the company's pension obligations.

Interim Steps

Companies have told us that they need to know what their cash requirements are for funding next year's funding obligation by the end of the second quarter of this year, but further work is needed to define an accurate measurement of pension liability. While we have considered alternatives to the discount rate methodology proposed in H.R. 1776, we are not yet to the point of offering a specific replacement. Yet we agree with those who say that quick congressional action on modifying current law is essential, both because in the absence of such action the law reverts to a discount rate methodology that would be even more distorting than the current rate and because plan sponsors need certainty soon in order to plan for next year's funding requirements.

To that end, we recommend that Congress enact legislation before the end of this June to extend the short-term interest rate corridor relief that Congress provided in 2002. We would propose that, for plan years beginning in 2004 and 2005, the upper bound of the interest rate corridor for the deficit reduction contribution continue to be 120 percent of the 4-year weighted average of the yield on 30-year Treasury securities.

During the time offered by the two year extension, we would look forward to working with Congress and pension stakeholders to work through the complex but critical issues I have described that must be addressed to ensure accurate pension liability measurement and, more importantly, advance our ultimate objective of making pensions more secure.

The change in the method of determining pension liabilities may result in changes in the annual contribution amounts, so transition relief will be required. In addition, these changes should lead us to consider changes in the current funding rules which would increase the security of the pension promises made to America's workers and their families.

I would like to stress the need for quick action on this temporary extension of the corridor. This action is needed to give companies time to budget for next year's funding obligation. At the same time, however, we must also move quickly to deal with the complex questions I have outlined in my testimony. We need to work expeditiously to come up with a permanent solution, not just for how best to measure liabilities but also for the funding rule changes that are needed. The testimony you are about to receive from PBGC's Executive Director Steve Kandarian illustrates the urgency of the work before us. We look forward to working with you to advance this interim solution and to satisfy the long-term need for accuracy in the measurement of pension liabilities.

Conclusion

Defined benefit pensions are a valuable benefit and the cornerstone of many workers' retirement security. Recent financial market trends have exposed underlying weaknesses in the system, weaknesses that must be corrected if that system is to remain viable in the long run. It will take considerable time and effort to fix the system. Developing acceptable solutions will also require the cooperation and flexibility of all interested parties.

While we must avoid unnecessary delay, the seriousness of current pension problems and the complexity of the defined benefit system suggest that repairing the system will require time for study and for consensus building. That is why we recommend that Congress, rather than making a permanent replacement for the 30-year Treasury rate this year, extend for an additional two-year period the temporary increase of the pension discount rate used to compute current liability.

During this two-year period government, industry, and participants will have adequate time to develop a set of consistent coherent proposals that will insure that pension funding is adequate, that pension demands on firm finances are reasonable and that the financial integrity of the pension insurance system will be maintained for the workers and retirees that are counting on it for their retirement security.

Chairman MCCRERY. Thank you, Mr. Fisher. Mr. Kandarian.

STATEMENT OF THE HONORABLE STEVEN A. KANDARIAN, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Mr. KANDARIAN. Chairman McCrery., Ranking Member McNulty, and Members of the Subcommittee, I want to thank you for holding this hearing today on pension plan funding and for your interest in the retirement security of America's workers.

My testimony will focus on the state of the PBGC and the DB pension system and on pension funding issues. Last year, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion, a net loss of $11.3 billion in just 1year. This loss is more than five times larger than any previous 1-year loss in the Agency's 28-year history. Moreover, based on our midyear report, the deficit has now grown to about $5.4 billion. Because PBGC receives no Federal tax dollars, it is premium payers, employers that sponsor DB plans, who bear the cost when the Agency takes over underfunded pension plans.

During the last 2 years, PBGC has become responsible for plans with billions of dollars in underfunding; $1.3 billion for National Steel, $1.9 billion for LTV steel, and $3.9 billion for Bethlehem Steel. Just last month the U.S. Airways pilot plan presented a claim against the insurance system of $600 million.

The worst may not be over. In plans sponsored by companies with below investment grade credit ratings, our exposure to pension underfunding has more than tripled, from $11 billion to $35 billion, and that number will be higher in fiscal year 2003. Even though our current $5.4 billion deficit is the largest in the Agency's history, it does not create an immediate liquidity problem for PBGC. We will be able to continue paying benefits for a number of years, but putting the insurance program on a sound financial basis is critical.

Some have argued that because PBGC is not in any immediate danger of running out of cash, there is no need for Congress to address the issue of pension underfunding. We believe this view is misguided. We should not pass off the cost of today's problems to future generations. Data now available to PBGC confirms the total underfunding in the single-employer DB system exceeds $300 billion, the largest number ever recorded in the system.

The airline industry alone now has $26 billion in underfunding and the automotive sector more than $60 billion. In light of the staggering amounts of underfunding, we are concerned that a number of proposals now under consideration would weaken existing pension funding rules by granting permanent funding relief.

Mr. Chairman, there are a number of challenges facing the DB system. First, the current rules are inadequate to ensure sufficient pension contributions for chronically underfunded plans. The funding targets are simply not high enough for companies at the greatest risk of termination. Another defect is allowing plan assets and liabilities to be "smoothed," which can reduce contributions. Finally, nothing in the funding rules requires companies with underfunded plans to make cash contributions to their plans every year.

In an effort to strengthen the DB system, PBGC and the U.S. Department of Labor, Department of Treasury, and U.S. Department of Commerce are currently examining a number of long-term reforms in four areas. First, as Secretary Fisher has discussed, we must accurately measure pension assets and liabilities. Some groups want to substitute a single, smooth, long-term corporate bond rate for the 30-year Treasury rate as a means of providing permanent funding relief. The PBGC's calculations indicate that this proposal would allow plan funding to fall below the already low levels permitted under current law.

Second, plan sponsors should not make pension promises that they cannot keep. Under current law, benefits can be increased even if a plan is only 60 percent funded. In addition, many companies with underfunded plans are not required to make annual pension contributions. These and other weaknesses in the current rules underscore the importance of getting pension plans funded to an appropriate target in a reasonable period of time.

Third, pension plan information must be transparent. The current value of plan assets and liabilities is not available to workers, retirees, investors, or creditors. Moreover, the most current information regarding the funded status of plans is provided to PBGC but is not provided to the public. Timely, accurate data would enable the capital markets to inject further discipline into the system and allow all stakeholders to better protect their interests.

Finally, we must ensure the long-term stability of the pension insurance system. Under current law, PBGC is exposed to losses from shutdown benefits, benefits triggered by plant shutdowns or permanent layoffs that companies typically do not fund and for which no specific premium is paid. In addition, the present premium structure does not reflect the risk of a claim from a given plan. While we believe that well-funded plans represent a better solution to any premium changes, we should not rule out premium increases as an option at a time when the Agency has a large and growing deficit.

Mr. Chairman, the existence of the pension insurance program creates moral hazard, tempting management and labor and financially troubled companies to create pension promises that the companies are unable to keep. These unfunded promises increase the cost that chronically underfunded pension plans impose on the DB system.

Financially strong companies at some point may exit the DB system, leaving only those that pose the greatest risk of claims. This potential for adverse selection could pose a serious problem for the insurance program. The funding rules must be carefully examined and strengthened to ensure the long-term viability of the pension system. Better-funded pension plans are critical to the retirement security of American workers.

Again, I thank you for inviting me to testify this afternoon.

[The prepared statement of Mr. Kandarian follows:]

Statement of The Honorable Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation

Chairman McCrery, Ranking Member McNulty, and Members of the Subcommittee:

Good afternoon. I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing on pension plan funding and for your interest in the retirement security of America's workers. The way we address these complex issues is critically important to the financial well being of America's workers and retirees and to the financial health of plan sponsors.

I am going to focus on the state of the PBGC and the defined benefit pension system, as well as funding issues that directly impact PBGC. During FY 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion—a loss of $11.3 billion in just one year. This loss is more than five times larger than any previous one-year loss in the agency's 28-year history. Moreover, based on our midyear unaudited financial report, the deficit has grown to about $5.4 billion. Furthermore, data now coming in to PBGC confirm that the total underfunding in the single-employer defined benefit system exceeds $300 billion, the largest number ever recorded.

In light of these record deficits and staggering amounts of pension underfunding, we are concerned that a number of proposals now under consideration would weaken existing funding rules and grant permanent funding relief.

State of the PBGC

PBGC was created as a federal corporation by the Employee Retirement Income Security Act of 1974 (ERISA). PBGC protects the pensions of nearly 44 million workers and retirees in more than 32,000 private defined benefit pension plans. PBGC's Board of Directors consists of the Secretary of Labor, who is the chair, and the Secretaries of the Treasury and Commerce.

PBGC insures pension benefits worth $1.5 trillion. In addition, PBGC is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. As a result of the recent terminations of several very large plans, PBGC will be responsible for paying nearly $2.5 billion in benefits to nearly 1 million people in FY 2003, up from $1.5 billion in FY 2002.

No Full Faith and Credit; No Federal Tax Dollars

While PBGC is a government corporation created under ERISA, it is not backed by the full faith and credit of the United States government. Moreover, PBGC receives no federal tax dollars. Instead, PBGC is funded by four sources: insurance premiums paid to PBGC by defined benefit pension sponsors; assets of pension plans that PBGC has trusteed; recoveries in bankruptcy from former plan sponsors (generally only cents on the dollar); and earnings on invested assets.

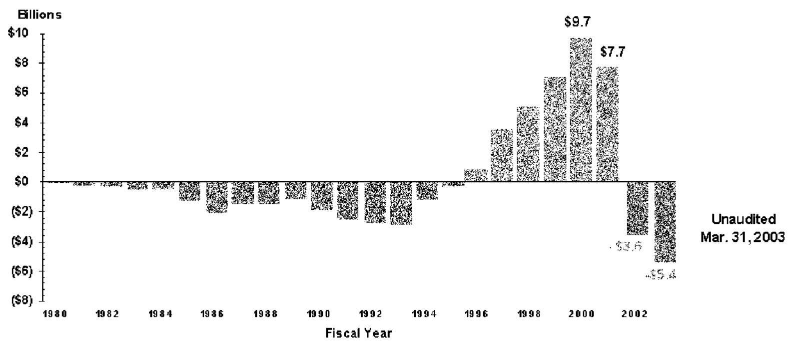
When PBGC takes over pension plans that are underfunded by billions of dollars, it is the premium payers—employers that sponsor defined benefit plans—who bear the cost. Financially healthy companies with well-funded pension plans end up subsidizing financially weak companies with chronically underfunded pension plans. As a result, over time, strong companies with well-funded plans may elect to leave the system. This potential for "Adverse selection" could pose a serious problem for the insurance program.

Health of PBGC's Programs

PBGC operates two financially independent insurance programs, the larger single-employer program and a smaller program for multiemployer plans (i.e., plans set up between a union and two or more employers). The multiemployer program has been in surplus since 1980. The single-employer program, however, was in deficit for 21 years from 1974 until 1995.

For six years, from 1996 until 2001, the single-employer program was in surplus, reaching a surplus of nearly $10 billion in FY 2000. The surplus grew substantially during these years because of PBGC's investment gains during the stock market boom and because PBGC did not have to trustee any plans with large amounts of underfunding. During FY 2001 and FY 2002, however, PBGC's surplus rapidly deteriorated. At the end of fiscal 2002 (September 30, 2002), the surplus had disappeared altogether, leaving PBGC with a deficit of $3.6 billion. As of March 31, 2003, our unaudited deficit has grown to about $5.4 billion.

PBGC Net Position, Single-Employer Program, FY 1980–FY 2002

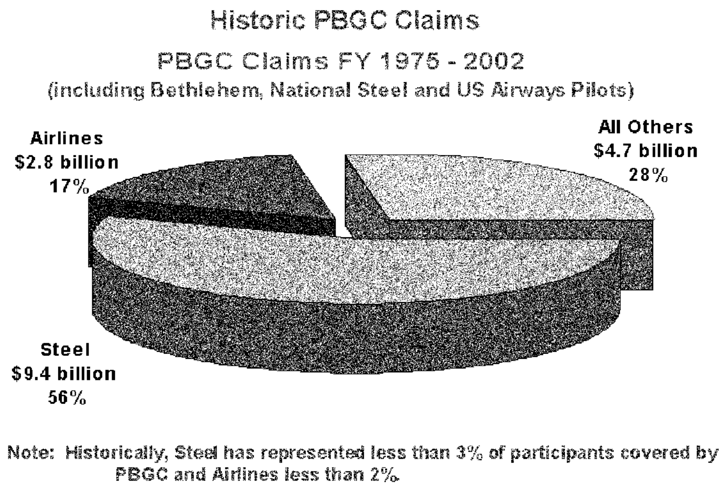


Our deficit has been caused by the failure of a significant number of large companies with highly underfunded plans. These include the plans of Trans World Airlines; retailers including Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including LTV, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango. Mr. Chairman, pension claims for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

There are significantly underfunded plans in a number of industries, including steel, airlines, and the automotive sector. Two of these industries, steel and airlines, have accounted for 73 percent of the claims against PBGC, yet represent fewer than 5 percent of insured participants. Steel, with less than 3 percent of participants, has accounted for 56 percent of PBGC's claims, and airlines, with about 2 percent of participants, have constituted 17 percent of claims.

In December 2002, the plans of two major steel companies, Bethlehem and National Steel, terminated with combined underfunding of over $5 billion. And just last month, the US Airways pension plan for pilots terminated with underfunding of $2 billion.

That is what's in the door. Still looming is $35 billion in vested underfunded claims in "reasonably possible" plans sponsored by financially weak companies, according to PBGC's FY 2002 estimates. When this number is updated for FY 2003, the reasonably possible figure will be much higher. Because PBGC has now absorbed most of the steel plans, the airline and automotive sectors represent our biggest exposure. The airline industry now has $26 billion of total pension underfunding. In the automotive sector—comprised of auto, auto parts, and tire and rubber companies—total pension underfunding exceeds $60 billion.



The termination of large plans with low funding levels drove PBGC into deficit, and additional large claims may increase that deficit. Even though the current $5.4 billion dollar deficit is the largest in the Agency's history, it does not create an immediate liquidity problem for PBGC—we will be able to continue paying benefits for a number of years. But, putting the insurance program on a sound financial basis is critical. We should not pass off the cost of today's problems to future generations.

Recently, some have argued that, because PBGC is not in any immediate danger of running out of cash, there is no need to address the issue of pension underfunding. We believe this view is misguided.

Mr. Chairman, Congress heard the same argument in 1987 and again in 1994 when Congress strengthened pension security for workers. Without those reforms, workers and the PBGC would be in even worse shape today and plan sponsors would be digging themselves out of an even larger underfunding hole.

State of the Defined Benefit Pension System

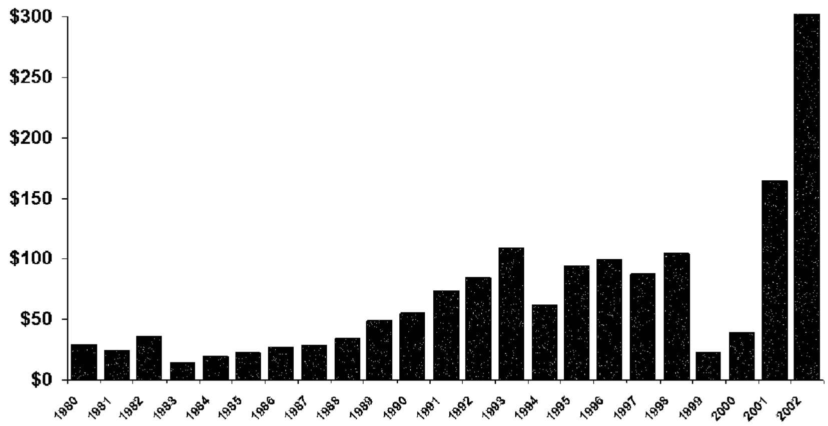
Defined benefit plans are an important source of retirement income security for rank-and-file American workers. The defined benefit system, however, has serious structural problems that need to be addressed.

As you know, Mr. Chairman, our pension system is voluntary. In recent years, many employers have chosen not to adopt defined benefit plans, and other employers have chosen to terminate their existing defined benefit plans. Since 1986, 97,000 plans with 7 million participants have terminated. In 95,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. The remaining 1,800 were PBGC terminations where companies with underfunded plans shifted their unfunded pension liabilities to the insurance program, resulting in benefit reductions for some participants and premium increases for other pension plan sponsors.

Of the 32,000 defined benefit plans that remain ongoing, many are in our most mature industries. These industries face growing benefit costs due to an increasing number of retired workers.

At the same time, plan assets, which typically are invested over 50 percent in equities, have suffered a large decline and pension liabilities have ballooned due to falling interest rates. Last year over 270 corporations reported to PBGC that they had pension plan underfunding greater than $50 million. This is more than three times the number of corporations that have reported to PBGC in any year in the past, and we expect the number to be higher still this year.

Total Underfunding Insured Single-Employer



PBGC estimates from Form 5500 and Section 4010 Filings

Top 10 Firms Presenting Claims FY 1975—Present				
	Fiscal Year of Plan Termination	Claims (Billions $)	Covered Participants	Funded Ratio*
Bethlehem Steel	2003	$3.9	95,000	45%
LTV Steel	2002	1.9	79,600	50%
National Steel	2003	1.3	35,400	47%
Pan American Air	1991, 1992	0.8	37,500	31%
Trans World Airlines	2001	0.7	34,300	47%
US Airways Pilots	2003	0.6	7,200	64%
Eastern Air Lines	1991	0.6	51,200	65%
Wheeling Pitt Steel	1986	0.5	22,100	27%
Polaroid	2002	0.4	11,400	67%
Sharon Steel	1994	0.3	6,900	21%

* Funded ratio at termination for PBGC benefits; participants lose additional benefits not covered by PBGC

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history—$600 million in underfunding for the Eastern Airlines plans and $800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the plans we have taken in lately: $1.3 billion for National Steel, $1.9 billion for LTV Steel, and $3.9 billion for Bethlehem Steel. Underfunding in some troubled airlines is even larger.

With pension promises growing and plan funding levels at their lowest point in more than a decade, the dollar amount of pension underfunding has skyrocketed. Meanwhile, PBGC's premium collections over the past decade have remained flat at roughly $800 million a year. In fact, premium revenue for FY 2002 was at its lowest level since 1991.

Challenges Facing the Defined Benefit System

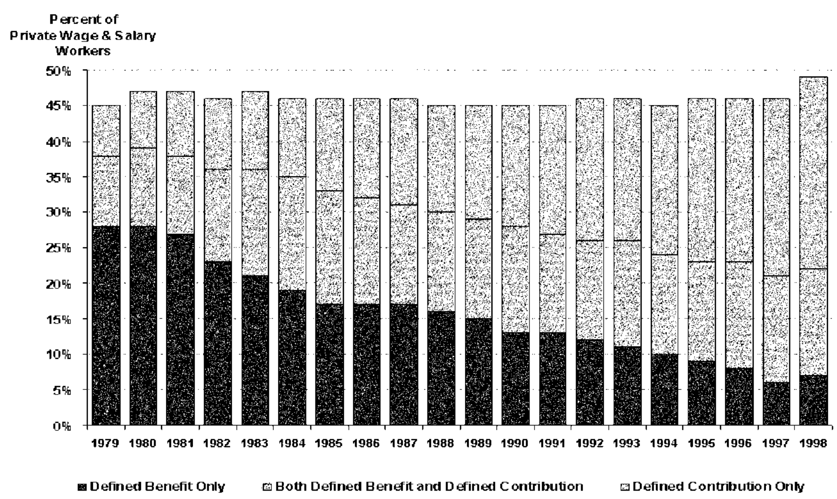
Mr. Chairman, there are a number of challenges facing the defined benefit system. One of the most fundamental challenges is that the current funding rules are inadequate to ensure sufficient pension contributions for those plans that are chronically underfunded. To our knowledge, none of the defined benefit pension plans responsible for the $300 billion in underfunding is in violation of law. Companies with hugely underfunded plans have followed the funding requirements of ERISA and the Internal Revenue Code.

When PBGC trustees these underfunded plans, participants often complain that "there ought to be a law" requiring companies to fund their plans. Mr. Chairman, there is a law, but it is inadequate to fully protect the pensions of America's workers when their plans terminate. The funding targets are simply not high enough for the plans of companies at the greatest risk of termination. Another defect in the funding rules is permitting plan assets and liabilities to be smoothed, which can reduce contributions. Finally, nothing in the funding rules requires companies with underfunded pensions to make annual cash contributions to their plans.

Another trend impacting the defined benefit system is increased competitive pressures that have led companies to reexamine their entire cost structure. In the 1990s, companies noticed that many workers did not place a high value on their defined benefit plans, compared to the value they placed on their 401(k) plans. Furthermore, companies became concerned that their financial obligations to defined benefit plans were highly volatile, in part because of fluctuations in interest rates and a dependence on equity investment gains. This volatility can make business planning difficult. As a result, many companies have been increasingly unable to afford, or unwilling to maintain, defined benefit plans.

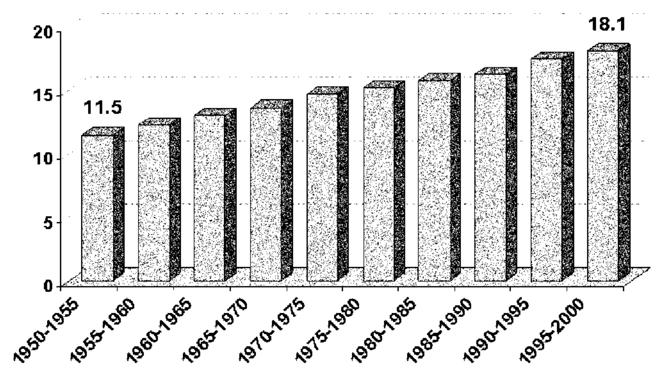
In addition, companies found that demographic trends have made defined benefit plans more expensive. With workers retiring earlier and living longer, plans must pay annuities for far longer. Today, an average male worker spends 18.1 years in retirement compared 11.5 years in 1950, an additional seven years of retirement that must be funded.

Pension Participation Rates 1979—1998



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1998 Form 5500 Annual Reports Winter 2001—2002

Changing World—Demographics
Average Number of Years Spent in Retirement (Males)



Problematic Pension Proposals

Mr. Chairman, we have seen or heard of a number of proposals for changes in ERISA that would allow companies to reduce their pension contributions. There are proposals to lengthen the amortization periods for funding; to allow the use of weaker mortality tables; to reduce variable rate premiums paid to PBGC by seriously underfunded plans; to weaken pension contributions for certain companies and industries; and to allow benefit increases even when a pension plan is less than 60% funded.

These proposals all have the same impact of reducing contributions to seriously underfunded plans. To grant temporary relief to pension sponsors in financial difficulty is one thing. But to change ERISA in the ways being proposed would institutionalize greater long-term underfunding with potentially grave consequences for the defined benefit system.

Reform Principles

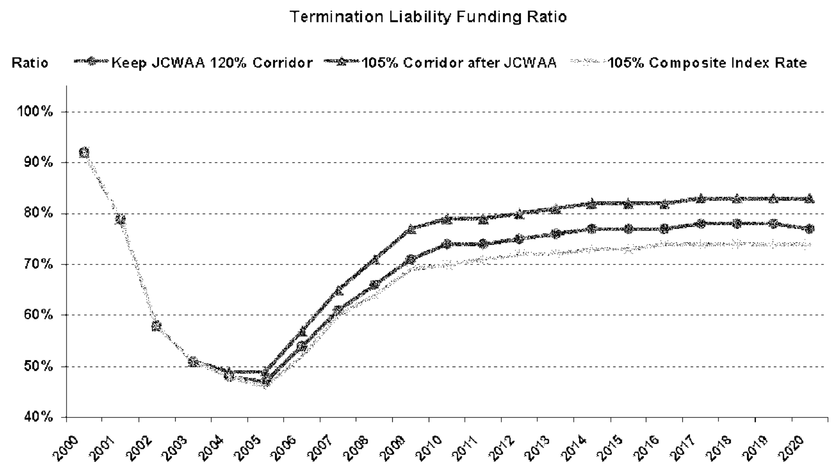
In an effort to improve pension security for workers and retirees by strengthening the financial health of the defined benefit system, PBGC and the Departments of Labor, Treasury, and Commerce are currently examining a number of long-term reforms. These ideas are still being refined, but I would like to share with you some of our thoughts.

Correct Measurement of Assets and Liabilities

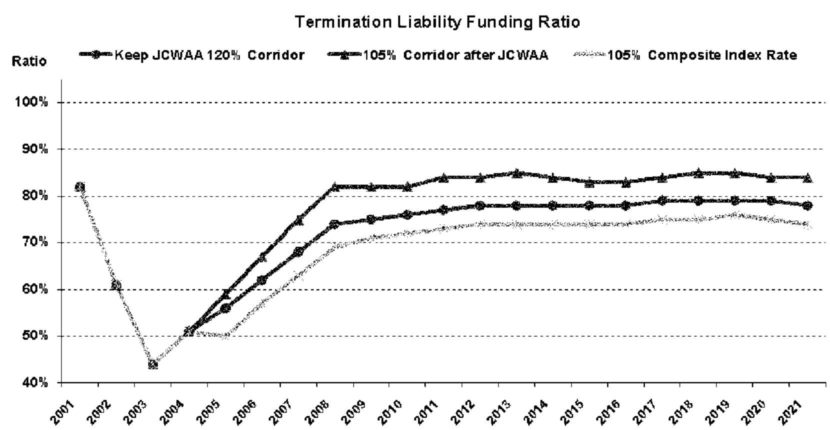
Secretary Fisher has discussed some of the issues that would need to be addressed before settling upon a permanent replacement for the 30-year Treasury rate. As he said, the Administration believes that Congress should provide a temporary solution for two more years. The Administration also recognizes the importance of accuracy, transparency, and the time structure of these liabilities. I would like to emphasize the importance we place on strengthening the funding rules at the same time that a permanent replacement is adopted for 30-year Treasuries.

Some groups want to substitute a single, smoothed long-term corporate bond rate for the 30-year Treasury rate as a means of providing permanent funding relief. But as PBGC's calculations indicate, this proposal would allow plan funding to fall below the already low levels permitted under current law.

Proposal Illustration (effective 01/01/2004)
Mature Manufacturing Company



Proposal Illustration (effective 01/01/2004)
Airline Company



Composite Rate consists of Moody's Aa Long Term Corporate Bond Index, Merrill Lynch 10+ High Quality Index, Salomon Smith Barney High Grade Credit Index, and Lehman Brothers Aa Long Credit Index.

Mr. Chairman, we are concerned about the financial integrity of the defined benefit system. While we support extending the current temporary solution for another two years, we believe that this time should be used to carefully examine the current funding rules and strengthen them so as to put the system on a sound financial footing over the long run.

Funding

Plan sponsors must not make pension promises that they cannot or will not keep. For example, under current law benefits can be increased as long as the plan is at least 60% funded. In too many cases, management and workers in financially troubled companies may agree to increase pensions, in lieu of larger wage increases. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and may ultimately be passed on to PBGC's premium payers if the company fails.

Under current law, many companies with underfunded plans are not required to make annual pension contributions. A significant number of highly underfunded pension plans recently trusteed by PBGC were not required to make contributions for a number of years prior to termination. Moreover, in several cases, these companies paid little or no variable rate premiums to PBGC in the years leading up to termination. These and other weaknesses in the current rules underscore the importance of getting pension plans funded to an appropriate target level over a reasonable period of time without putting a company in financial distress.

Transparency/Disclosure

Mr. Chairman, pension plan information must also be transparent. Pension plans must be required to provide understandable information that best reflects the current state of plan assets and liabilities. The current value of plan assets and liabilities is not transparent to workers, retirees, investors, or creditors, and the current disclosure rules do not require timely data that would help participants and shareholders understand the funding status of plans and the consequences of pension underfunding. Timely, accurate data would enable the capital markets to inject further discipline into the system and allow all stakeholders to better protect their interests.

Congress added new requirements in 1994 providing more timely data to PBGC and expanding disclosure to participants in certain limited circumstances, but our experience tells us these disclosures are not adequate. The information provided to PBGC is confidential, so its impact is limited. And the notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. Workers in many of the plans we trustee are surprised when they learn that their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including certain early retirement benefits.

Long-term Stability of the Pension Insurance Program

Mr. Chairman, we believe changes should be made to strengthen the long-term stability of the defined benefit insurance system. For example, in many cases current law requires that PBGC pay shutdown benefits—early retirement benefits triggered by plant shutdowns or permanent layoffs—that companies typically do not fund and for which no specific premium is paid to PBGC. These shutdown benefits—which are similar to severance benefits not guaranteed by PBGC—account for billions of dollars of PBGC's unfunded liability exposure. We are considering whether plan sponsors should be allowed to offer shutdown benefits as part of an insured pension plan.

PBGC is also examining its premium structure in light of the massive increase in claims. Under the current structure, premiums are computed based solely on the number of plan participants and the dollar amount of pension underfunding. The formula does not attempt to reflect the risk of a claim from a given plan. While we continue to believe that well-funded plans represent a better solution for participants and the pension insurance program than any changes on the premium side, we should not rule out premium increases as an option at a time when PBGC has a large and growing deficit.

Conclusion

In closing, I would like to cite the remarks of the former chairman of the Ways and Means Oversight Subcommittee the last time ERISA funding was considered. Representative J.J. [Jake] Pickle was one of the chief advocates of the 1987 and 1994 reforms. His comments on the floor at the time the 1994 pension reforms were enacted are worth remembering:

> "I note that I would have personally preferred to make these reforms much stronger, and I caution my colleagues that they should not expect these reforms to immediately solve all the problems caused by underfunded pension plans. In order to overcome strenuous objections by certain automobile, steel, and airline companies we have included very generous transition rules for companies which have maintained chronically underfunded pension plans. . . . I deeply regret that we have given another reprieve to companies who have shirked their pension obligations for the 20 years since the passage of [ERISA]."

Congressional Record, 103rd Cong., 2nd Sess., H11477, Nov. 29, 1994.

Mr. Chairman, the existence of the pension insurance program creates moral hazard, tempting management and labor at financially troubled companies to make pension promises the companies later find they are unable to keep. These unfunded promises increase the cost that chronically underfunded pension plans at weak companies impose on the defined benefit system. Over time, this leads to higher premiums for all plan sponsors. Financially strong companies at some point will have had enough, and will exit the defined benefit system, leaving only those which pose the greatest risk of claims. We need to make sure that the incentives in the system are changed so this doesn't happen.

The funding rules need to be carefully examined and then strengthened to ensure the long-term viability of the pension system. The funding rules should encourage companies to make regular contributions to reach an appropriate funding target. Making defined benefit plans better funded is important to providing retirement security to American workers.

Again, I thank the Chairman for inviting me to testify this afternoon. I will be happy to answer any questions.

Chairman MCCRERY. Thank you, Mr. Kandarian. Mr. Fisher, is there a general consensus that the 30-year Treasury rate should be replaced as the benchmark for pension plan calculations?

Mr. FISHER. Well, I am certainly of that opinion. I know there are some academics who continue to think that the 30-year Treasury rate provides a good measure. That is not my opinion and it is not our opinion.

I think that the difficulties with the 30-year Treasury rate were actually evident prior to our discontinuation of the use of the instrument for Federal borrowing. As the Federal Reserve squeezed inflation out of our economy over the last part of the decade of the nineties, the relationship that markets had become used to as to how high a yield curve we had, how steep a yield curve we had, began to change. I think even so, in the middle- and late-nineties, the pension industry began to reflect on the changing structure of the yield curve and began to see the Treasury rate as not being an appropriate reflection of the private annuity costs which Congress had been looking at as a good measure in 1987.

Chairman MCCRERY. Do you think there is any consensus, or to what extent is there a consensus, in your opinion, that we should move away from a government rate and move toward some corporate bond rate?

Mr. FISHER. We are of that opinion and I am of that opinion. As I say, the academic community I would say is still divided. I think that my own view is that the accuracy of the measurement will be enhanced if we reflect the nature of the liabilities we are looking at, that these are private claims, pensions do not get a full faith and credit guaranty, and they are riskier than that. Even with the system managed by Steve, we see that individuals don't receive everything that they originally bargained for. That is less than full faith and credit. It seems to me the private credit curve is the right place to look.

Chairman MCCRERY. So, although you hold these opinions, and your Department of Treasury does, and yet your recommendation is that for the next 2 years anyway, we stick to the current fix which depends on the 30-year Treasury rate.

Mr. FISHER. That is exactly right, because of the three issues identified in my testimony: the problems with lump sums, the problem with the time structure—and I am forgetting my third issue.

Chairman MCCRERY. What is the problem with those? Is it a substantive problem or is it a political problem?

Mr. FISHER. There is both the political, frankly, and a substantive problem on the lump sums in which it is very difficult to figure out how to get the right set of transition rules for individuals, as you were describing, and for plan funding. So, that is both the technical and, frankly, looking at the three interests that I described, the need to ensure the integrity of the PBGC, the need to get adequate funding, and the need to be reasonable, have reasonable burden for plan sponsors—trying to find your way through that is actually both the technical issue that I have not been able to solve yet on the lump sums and I think a very difficult political issue, because getting it wrong will exacerbate the problems we have now with the system.

Chairman MCCRERY. Well, the problem we have right now with the system is that the interest rate we are using to calculate the lump sum distribution is too low. Therefore the lump sum distribution is too high. Isn't that correct?

Mr. FISHER. In terms of the accuracy, I couldn't agree with you more. Now, how we get to a world of getting to—removing the arbitrage that has been introduced by the temporary extension that was provided last year is a challenge for us all to figure out how to get the right transition rules both for companies and individuals.

Chairman MCCRERY. You haven't figured that out yet.

Mr. FISHER. I have not. I am all ears.

Chairman MCCRERY. So are we.

Mr. Kandarian, in your testimony you noted that between 1980 and 1985, PBGC was in deficit and then ran a surplus from 1996 to 2001. The deficit that we are experiencing now, though, in 2002, 2003, is larger than those that you experienced in the nineties. Restate, if you would, how serious a problem it is today, given that it is higher than the levels we have experienced in the past levels of deficit.

Mr. KANDARIAN. I think it is a very serious problem, especially if you take into account the level of underfunding in the entire system, the $300 billion number that I mentioned. The Agency takes in about $800 million a year in premiums for its single-employer program. We have hanging out there in the private sector currently $300 billion in underfunding. Now, we don't guarantee 100 percent of that, as Secretary Fisher has mentioned, but we guarantee most of it, the large share of it, the vast majority. The question is how many of these financially troubled companies will end up ultimately terminating their pension plan and coming into this Agency highly underfunded. So, given the size of this insurance system, given the size of the DB system, I find that troubling.

Chairman MCCRERY. If the economy were to improve, wouldn't that bring us somewhat back into a brighter picture in terms of the deficit of the PBGC?

Mr. KANDARIAN. It would. An improving economy should result in fewer companies going out of business and therefore having their pension plans come into us. In addition, presumably the stock market would do better in that situation and assets in plans would grow in value, since most companies have over half their assets in pension plans in the equity markets. So, that would reduce the level of exposure.

Chairman MCCRERY. So, at least one thing that the Congress should maybe focus on is getting the economy growing again.

Mr. KANDARIAN. That is right.

Chairman MCCRERY. You caution against increasing the interest rate benchmark because of the PBGC's financial status. While the financial status of the PBGC is a concern, we know that using an artificially low interest rate has detrimental effects on the companies that are providing these benefits. It increases their liabilities to the PBGC, which take cash out of their hands which they wish they could use to hire more employees, to pay their employees more, to invest in plant and equipment or whatever. So, how do we strike a balance between your need for better funding and companies' needs to keep as much cash as possible to do their business?

Mr. KANDARIAN. I think there are really two separate issues here. One is accurately measuring pension liabilities. That is what Secretary Fisher has been talking about. Once you know what the accurate measure of those liabilities is, you then have to have good funding rules, strong funding rules to get these plans to fund up to some reasonable level over some period of time.

Let me give you an example. We ran some computer models using different interest rates and we picked the 10 largest companies in the DB system that have underfunded pensions today. Five years from now, if you simply kept the 120 percent measure of measuring liabilities that you have today, and then compare that to a composite bond rate, you would see a 4-percent further drop in funding. It would actually go from 77 percent at 105 percent Treasuries, to 70 percent at 120 percent Treasuries, down to 66 percent using a composite bond rate. What is important to note in all those cases, the plans may be underfunded across the board regardless of which interest rate you choose.

Chairman MCCRERY. Well, let's look at some specific examples. You note that several of the airlines have declared bankruptcy and they were in full compliance with the funding rules. Many did not have to make additional contributions to their plans, pay additional PBGC premiums, or provide notices to workers that their plan was underfunded. Yet now we know that they are plans were somewhat underfunded. What happened?

Mr. KANDARIAN. Well, there is a great deal of averaging and smoothing, as we discussed earlier. You can smooth out your assets, for example over a 4-year period of time or even longer. So, if you assume you still have in your asset pool the year 2000 stock market values, to some degree, that misstates the current status of your plan. The same thing occurs on the interest rate side. Interest rates have been coming down dramatically in the last 3 years. That increases liabilities on a termination basis, or on a current basis, but those numbers are all smoothed and you end up with liabilities that are reflecting, really, past economic circumstances, not the current circumstance.

So, for example, even outside the airline industry we had Bethlehem Steel come in with over $4 billion in underfunding, and they weren't required to make a payment until July of 2003 and hadn't made one for years. So, those are some of the weaknesses that you are correctly pointing out in the current funding rules.

Chairman MCCRERY. Do you have any recommendations for fixing those problems?

Mr. KANDARIAN. Well, we do have the task force I mentioned of the Department of Treasury, Department of Labor, Department of Commerce, and PBGC. We are deeply involved in these issues. I think we are coming pretty close to putting together a package of funding rule proposed changes. One concept we are certainly looking at very closely is trying to make sure that companies don't go through long funding holidays where no monies are going in for years. Oftentimes during the boom times, when they actually have the ability to put monies into their plans, and then when things turn around in an economic slowdown, the rules kick in eventually, and the size of the funding becomes extremely burdensome to these companies. So, finding some way to smooth out the contribution side of the system I think would be a big plus.

Chairman MCCRERY. Thank you very much. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I thank both of the witnesses. The Chairman covered the question I had for Mr. Kandarian. I would just like to ask Secretary Fisher the general question, if we adopt the standard that adds more complexity to the DB plan system, what long-term impact do you anticipate those measures would have on the viability of employer-sponsored pension plans?

Mr. FISHER. Well, the cash flow and time-value of money issue identified, and in my written testimony I also identified that there is a concern that it could add some complexity, is, I think, an important issue to identify, to think about the long-term viability of the DB system. On one level you can think of this as adding complexity, but on the other it gets to an accuracy issue will mean that plans that don't need to have as much funding don't have that burden.

I think most Americans understand that if you go to the bank, you get a different rate on a certificate of deposit for 1 year than you do for 10 years. So, that the time-value of money matters.

Now, most of the big plans, I am confident, are fully aware of the time-value of the payments—that is, the payment flows that are expected next year versus 5 years from now—with some accuracy, because indeed I think they have to have those for financial accounting purposes. So, I don't think it is that complex for them to come up with an understanding of their cash flows. One of the difficulties we have here is there is one set of rules for accounting purposes and the Securities and Exchange Commission (SEC) disclosure; then over here we have got a different set of rules. There is a lot of confusion and uncertainty out among investors as to what is the right measure. I think that is adding to the difficulties companies are facing now.

I want to be clear, we think that transition rules to help companies along deal with these burdens may be necessary, and we want to get to talking about that, but we don't think the measurement of the liability is the right place to put that. Let's get to an accurate measure before we get to the transition rule issue.

Let me finally say I think that for a lot of DB plans, this is not a burden for them; most of them go and buy private annuities when someone takes out a lump sum or to sustain their operations, and they have these—cash flows are priced in when the insurance company prices them the annuity.

Mr. MCNULTY. Thank you. Mr. Chairman, since she has a 4:00 p.m. commitment elsewhere, I would like to yield the balance of my time to Ms. Tubbs Jones.

Ms. TUBBS JONES. Thank you, Mr. Chairman, Ranking Member.

Mr. Fisher, let me pick up right where you were just talking about private annuities to fund pension plans. You are familiar I am sure with the proposed dividends tax cut.

Mr. FISHER. Yes, I am, ma'am.

Ms. TUBBS JONES. We had testimony previously from some the insurance companies that the dividends tax cut would in fact impact annuities. If that is true, it is possible that they may well impact some of the private pension plans that are funded by annuities.

Mr. FISHER. It is possible. I am not familiar with the details. I know that there are people trying to work on the technical issues there, and I have not been a part of that. You are right; you are identifying an issue that we have been addressing at the Department of Treasury.

Ms. TUBBS JONES. Would you please do some work and get back with me on the impact it might have on the DB plans? We had a whole host of people from the insurance industry here discussing that very issue with us. It seems to me as we go down this road to decide how we are going to fund pension plans, this is a logical area that we might focus.

Mr. FISHER. Absolutely. We would be very happy to do that.

Ms. TUBBS JONES. Thank you. One short question. I don't know how much time I have left. You use the term, Mr. Kandarian, "smoothing." For the record, would you define smoothing for me, please?

Mr. KANDARIAN. Yes. Smoothing is used throughout the system in a couple of different ways. One, the assets of a pension plan where a company can smooth for 3, 4, or 5 years the value of those assets; an average actually.

Ms. TUBBS JONES. Define "smooth" for me.

Mr. KANDARIAN. They average the value of those assets over a period of time looking backward. So, today, for example, if a company were to sell its portfolio of securities, let's say it was worth $100; on a smooth basis, that number might be $130, especially if they held a lot of equities in their plan, which most do, and the equity markets are down on a broad basis.

Ms. TUBBS JONES. Who defines what a smooth basis is?

Mr. KANDARIAN. It is in the Tax Code, the Department of Treasury rules.

Ms. TUBBS JONES. Thanks. I yield back. Thanks a whole lot for the time.

Chairman MCCRERY. Mr. Collins, would you like to inquire?

Mr. JOHNSON. Thank you, Mr. Chairman, I appreciate that.

Chairman MCCRERY. Or Mr. Johnson, would you like to inquire?

Mr. JOHNSON. Who did you talk to?

Chairman MCCRERY. Mr. Collins, but he declined. So, I will go to you, Mr. Johnson.

Mr. COLLINS. I yield to the man with the power.

Mr. JOHNSON. All right. Thank you, Mr. Collins. I am wondering why the Department of Treasury doesn't want to come up with a fixed rate, because we have been temporary for some time. As I recall, I think it was Mr. Portman along with a couple of others and myself—Cardin was one of them—that sent you a letter back in November 2001—that is almost 2-years-ago—asking you to fix this rate. We never got a response. Today you are saying you don't want to fix the rate today, but that you want to do another temporary for a couple of years. I don't understand that. Could you explain it, please?

Mr. FISHER. Sir, I am very sorry if the Department of Treasury did not respond to you.

Mr. JOHNSON. I understand you got a new guy in there now. John Snow is a good one. That is beside the fact. Tell me why you want a temporary rate.

Mr. FISHER. We have not been able to come to a conclusion, we are working very hard with the Department of Commerce and the Department of Labor and the PBGC, as to how to deal with the three issues identified in my testimony. The issue that slipped my mind was the smoothing. I think that on the cash flows and having a proper—having it reflect it properly, those pension plans that have a lot of near-term payments, this is a very challenging issue, as is the lump sum. If I had a technical answer I would share it with you.

Mr. JOHNSON. Mr. Portman and Cardin have suggested using a basket of corporate bond indexes as a solution. Have you all considered that?

Mr. FISHER. Yes, we have. As far as that goes, I am very attracted to the idea of using a private credit curve, that is, corporate rates. If we are doing that in the name of accuracy to try to get a better, more accurate measure, we think it matters to look at the cash flows.

Let me try to use a simple example. If a company is going to have more than half its workers retire within the next 5 years, simply put, the better measure would be a 5-year rate. Some other company, half their workers might not be retiring for 30 years. In that case, it, roughly speaking, would be appropriate to use a 30-year rate. Those will be very different and we will get to different conclusions about the adequacy of their funding if we recognize the time-value of money.

Mr. JOHNSON. Okay. Well, I wish you would look at figuring out something permanent and try to get a response to this.

Mr. FISHER. I am eager to do the same, sir.

Mr. JOHNSON. Thank you. Mr. Kandarian, in Texas, as you know, we are dealing with the saga of American Airlines, and their pension funding is way under. In fact to come up to speed, it is going to cost them close to $3 billion in the next year, they say, which could force them into bankruptcy. In other parts of the country we have got auto and steel that have some of the same problems.

Can you tell me generally how underfunded some of the big plans are and what your responsibility is?

Mr. KANDARIAN. Congressman, one of the things that I mentioned in my testimony was that we would like to have the system be more transparent in terms of information. Unfortunately, under the law I can't disclose information about specific companies. That is the current state of the law.

Mr. JOHNSON. How many? You can give me a number. Is it 5, 10, 20, 100 companies?

Mr. KANDARIAN. Number of companies?

Mr. JOHNSON. Yes.

Mr. KANDARIAN. That are—I am sorry?

Mr. JOHNSON. Underfunded.

Mr. KANDARIAN. In the entire system?

Mr. JOHNSON. Yes, sure. Well, and you know the unions are underfunded as well, some of the union plans, so it wouldn't hurt if you made that a public issue as well.

Mr. KANDARIAN. Over half the plans are underfunded. There are about 32,000 plans.

Mr. JOHNSON. When you say underfunded, what do you mean; less than 90 percent?

Mr. KANDARIAN. It is really less than 100, but some can be dramatically underfunded. For example, the steel companies whose plans we took recently were, generally speaking, 30 to 50 percent funded when they came into us. We didn't guarantee all those benefits, but to a participant, to a worker, those plans were between 30 and 50 percent funded. I will tell you that the major network airlines as a group are approximately 50 percent funded on a termination basis.

Mr. JOHNSON. That is all the airlines.

Mr. KANDARIAN. All the network airlines, the major ones.

Mr. JOHNSON. Okay. In the case of United, for example, which is bankrupted, have you had to guarantee any of those pension plans yet?

Mr. KANDARIAN. We have not had to guarantee them yet. The question will end up being whether the company can emerge from Chapter 11 bankruptcy with the plans intact. The test basically is will the plans preclude United from emerging from bankruptcy. If the answer is yes, that they cannot get out of bankruptcy, then they could qualify under what is called a "disasters determination" and essentially put the plans to PBGC, one or more of their plans. That is what happened with U.S. Airways.

Mr. JOHNSON. Yes, sir. Thank you, Mr. Chairman. Thank you for your responses.

Chairman MCCRERY. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Fisher, I certainly appreciate your testimony. I look forward to working with you. I am somewhat disappointed that you are not prepared to make a more definitive judgment as to what we should be doing on the replacement rates. We know that a temporary fix is not the right answer. We know we have to do something. We know that there are problems with good benefit plans that are adequately funded with the current interest assumptions, and that if it favors the—could have some major impact on lump sums that need to be dealt with. The longer we wait, the more we jeopardize good plans.

So, I am somewhat surprised—it seems like the administration is prepared to work out all the problems on the dividend exclusion issue, which has many more complications than this issue, and are ready to make immediate judgments. On this issue which has been around for a long time, you are not prepared today to give us your definitive judgment. I find that somewhat disappointing because I know this Committee would like to act this year on the issue.

So, I just really would hope that we could—you raise good points. There is no question that there are different types of plans out there. We want to make sure they are adequately funded. We don't want to add to the problems of underfunded plans. I would hope that you would focus on it now so that we can get this issue resolved in this Congress and not have to wait any longer. Any help in that regard we would certainly appreciate.

Mr. FISHER. Well, if I could, I share your frustration, Mr. Cardin, and we look forward to working energetically. I want to be very clear the administration is not suggesting we need a 2-year extension of the current corridor, and will wait until the end of that to work on these issues. We need that extension to give plan sponsors certainty. The Department of Treasury staff will be at work tomorrow morning, if you would like, with the joint working group on tax staff level here on Capitol Hill. We have been working hard on these issues. I share your—and I applaud you and Mr. Portman for getting the bill forward.

I do believe, as—I don't know if you were in the room—how many times I have said that a private credit curve we think is the right starting point. I am very pleased to move the ball along there. We do think, though, that the cash flows, the lump sum and the smoothing, if we don't get the right answer there, we run the risk of doing more harm than good for the system as a whole.

Mr. CARDIN. We will look forward to your recommendations in that regard. Thank you, Mr. Chairman.

Chairman MCCRERY. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. So many questions, so little time. Now we have a vote called. I really appreciate you having this hearing and being able to vet some of these issues.

Some of these questions may have been answered earlier. One just general question, maybe to sort of lay the bigger picture here and maybe—Mr. Kandarian, you and I have talked about this generally—but if we could just lay this out, how many DB plans were there, say, in the mid-eighties and how many are there today?

Mr. KANDARIAN. There were approximately 114,000 DB plans in the mid-eighties, and today about 32,000.

Mr. PORTMAN. That is roughly the numbers that we have been working with. I think we need to think about this in the context of what we are talking about today. To those who would say that somehow by establishing this composite of long-term corporate bonds is going to hurt the DB plans; the DB plans are being hurt already. The number of plans that have been frozen in the last couple of quarters, to new participants, are a big concern.

For those of us who believe in DB plans and want to see them continue and strengthen, I think we need more than just, with all due respect, another 2-year extension of what is truly uncertainty. I understand, Mr. Fisher, you say the plans need certainty, so you are giving them certainty of another 2 years. It is just another 2 years. It is 2 years of what I believe to be an inaccurate measure still, and one that causes some of these good plans to look at their options, like freezing or like getting out of the business altogether and offering new entrants a defined contribution (DC) 401(k) or something like that. Sometimes we get away from that. We are looking at plans quickly leaving many midsize corporations, and they have already left the smaller companies.

The Employee Retirement Income Security Act (ERISA) section 4002, Mr. Kandarian, requires PBGC to encourage the continuation of maintenance of voluntary pension plans to benefit participants. We have received consistent reports that DB plans are being frozen, sometimes to all participants, sometimes to new participants. I just wonder what you are recommending to provide stability and encouragement to plan sponsors that are already in the system so that they will continue to have their DB plans.

Mr. KANDARIAN. I think one of the best things we can do is devise a funding structure that allows companies to put in moneys during good years and not have to wait until bad years to make up the difference. These plans are volatile from the point of view of the level of funding. It changes pretty dramatically because of the way they invest their assets.

As I mentioned before, the assets are typically over 50 percent equities. Those markets can move up and down with a fair amount of volatility. So, during good years, when oftentimes they are flush with capital and profits, they either have a funding holiday—there is no requirement to put money in—or in some cases they butt up against the maximum funding rules and they cannot put money in. To allow them to put moneys in during these good years I think would help take some of the volatility out of the system.

Mr. PORTMAN. That is something that I think probably our panelists coming up would embrace. I think they are, though, very concerned about some of the proposals that are out there with PBGC and possibly with the Department of Treasury to look at the cash flow, because it is complicated and because it doesn't provide them the certainty that they are looking for.

One just general question I have, looking at the big picture here—and maybe Mr. Fisher can reply to this. Do you think the 30-year Treasury rate was a good measure back when the 30-year Treasury rate was being issued? Do you think it was the right liability measure to have?

Mr. FISHER. I think we observed over the course of the nineties, even before we discontinued issuance, that it probably was losing whatever accuracy it might have had in the late eighties. As the inflation premium, frankly, was squeezed out of the economy, it became a less and less accurate measure. It may have been more of an anomaly in the eighties that it looked like a good proxy for private annuity rates.

Mr. PORTMAN. Back in the eighties when it was considered a good proxy for private annuity rates and therefore considered a good measurement tool, it didn't take into account cash flow, did it?

Mr. FISHER. No, it hasn't, but I think it should.

Mr. PORTMAN. Okay. I know we have got a lot of things to go over, but on the lump sum side—which is your second issue you raise in addition to smoothing—your testimony says here, it is worth considering whether a permanent replacement of a 30-year Treasury rate is needed for the purpose of calculating lump sums. Are you implying that the 30-year Treasury rate might be used, an obsolete measure like that, for lump sums?

Mr. FISHER. No, I am not. I think, though, that we have to look very carefully at making sure we don't accelerate the arbitrage now that has opened up under the current statute.

Mr. PORTMAN. What is your recommendation on lump sums in general? What is the administration's position on lump sums?

Mr. FISHER. We don't have a recommendation at this time. We would be eager to work with you and others to try to resolve what we see as the very difficult both technical and political, frankly, transition issues; how to get reasonable payment schedules for plan sponsors and how to be fair to plan beneficiaries.

Mr. PORTMAN. My time is up, but Mr. Johnson talked about the letter back in 2001. This is an issue we have all been looking at for some time and knowing that it was, I would say, even a crisis in some companies at a time when the economy is down, when companies are looking for ways to be able to help the bottom line and keep their employees, I know these are complicated issues, I know they are tough political issues.

Mr. Cardin and I have borne the brunt of that over the last couple of weeks with some articles that I think were inaccurate because they weren't based on all the information, which is very complicated. It sure would help—when you say it is complicated and political—politically if you would take a position. I know you have to work with PBGC but it is not much help to just offer a 2-year extension and say the administration doesn't have a position, when it has really been 3 years we have been struggling with these issues and we could use a little leadership.

Thank you, Mr. Chairman.

Mr. WELLER. [Presiding.] We have a vote under way right now. There are some Members that would like to ask questions, I know Mr. Pomeroy, and there may be others who hope to return in time to ask questions. I have a few I would like to share with the panel.

Mr. Fisher and Mr. Kandarian, thank you for participating and appearing before the Committee today. Pension calculations are pretty important to a lot of people. So, this is a significant issue that is before us today. Of course, what has driven us, that Department of Treasury-made decision this past couple of years to suspend the 30-year bond. Mr. Fisher, I was wondering from your perspective and given your expertise, and perhaps Mr. Kandarian you can address this as well, but if the Department of Treasury had not suspended issuance of the 30-year bond, would it today still be a viable rate for pension calculations?

Mr. FISHER. No, I don't think it would. I think there was actually a fair bit of literature in the actuarial community and in the pension-sponsor community in the late nineties addressing the in-adequacy of the 30-year, before any decision was made to suspend it. That was because the structure of interest rates, the relationship between Treasury and corporate spreads was changing, and the overall slope of the yield curve was also changing as the Federal Reserve succeeded in squeezing inflation out of our economy. So, I think that the pressure on DB liability measurement was already there before we suspended the 30-year.

Mr. WELLER. Okay. Mr. Kandarian, do you have a perspective or do you agree?

Mr. KANDARIAN. I defer to the Department of Treasury's position on this.

Mr. WELLER. Mr. Fisher, if the Department of Treasury were to decide to reissue the 30-year bond at some point in the future, do you see it ever again being considered for this purpose; or, based on what you just stated, do you think that will be consistent?

Mr. FISHER. At least on our current understanding of interest rates in the hypothetical you are offering, I don't think I would be recommending that it be considered here for these purposes. I also think it a sufficiently remote possibility, approaching zero, that it will be brought back. I also think that would be a reason not to wait and hold your breath for whether the Department of Treasury was going to reissue 30-year bonds.

Mr. WELLER. Mr. Fisher, do you think there is a benefit to using a Department of Treasury-issued instrument for pension calculations in terms of the openness and transparency of those markets?

Mr. FISHER. I think there certainly is a benefit and there was at the time that it was adopted in 1987. I think that overall, the transparency of our capital markets in this country has advanced tremendously over the last 15 years. I think that whereas in 1987 the use of private credit curves or corporate credit curves did not seem adequately transparent in the late eighties, I think that today with the information technology and all of the instantaneous information available to us, it is much more credible that we will get to a sufficiently transparent rate. Those are other issues. In my testimony today I only addressed the three major issues. There are a number of other technical issues that would need to be addressed to come to the right setting of how to use a private credit curve.

Mr. WELLER. Mr. Fisher, thinking in terms what the risks are in choosing an inaccurate rate, what are the risks involved with choosing the interest rate that is too high or one that is too low?

Mr. FISHER. An interest rate which is—well, in each direction we can get to overfunding or underfunding. If we underfund pensions, then we put at risk the beneficiaries, the workers, and retirees. If we overfund, we put too great a burden on the plan sponsors and run the risk of a declining population of sponsors willing to be in the DB universe. So, this is precisely why one of the things I always remind the Department of Treasury staff is the risks are more symmetric than we think. That is why we are so convinced we have to be very careful to get to accuracy; then, I want to be clear, consider changes to the funding rules and transition rules so that we are not too burdensome on companies if getting to a more accurate measure ends up raising the measured burden. So, I think that is a big reason to be very cautious before we risk doing some harm here.

Mr. WELLER. Okay, thank you, Mr. Fisher.

Just one last question for Mr. Kandarian. Several proposals have been discussed, such as a corporate bond index, a yield curve, and 2-year extension of last year's relief. How would those options affect plan funding and the financial status of the PBGC?

Mr. KANDARIAN. We have an illustration to the right there, which demonstrates what the funding levels would be based upon different interest rates. I mentioned, I think, earlier in my testimony, in response to one of the questions, we looked at the plans of the 10 sponsors with the largest underfunding. In 5 years from now, if we went back to the 105 percent of Treasury rate, those plans would be 77 percent funded. If you stayed at the 120 percent of Treasury rate that we have today and extended that for 5 years, the number would be 70 percent, again compared to 77 percent. If you dropped it to a composite bond rate it would drop from 77 percent to 66 percent funded. So, it would reduce fairly dramatically the level of funding of a system that already is underfunded today if that were the only change we were making. Which is why we are talking about the funding rules as well.

Mr. WELLER. All right. Thank you very much. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I want to begin by just expressing my disappointment with the recommendation the administration is bringing forward today. This is a thorny problem but it is not a new one. On November 28, 2001, Representatives Cardin, Portman, Johnson, and myself sent a letter to the administration asking for your guidance. I believe that we are doing great disservice to employers that are trying to keep the security of DB pension coverage available for their workers, especially in the face of this recession. So, to not have a more advanced plan, something with certainty, really tells me that—I will be blunt about it—someone has dropped the ball within this administration, probably at the Department of Treasury, to have the testimony today being we want a 2-year extension of the jury-rigged proposal we now have in place while we look at this some more.

It is bipartisan concern around here on retirement income security for workers. I think there is some agreement that the pension plan of the DB character has an enduring value to the marketplace. We want to find ways to expand it, not be inattentive to the problems that are forcing its diminishment.

I am very concerned, while the financial press has talked so much about cash balance conversions, one thing we don't seem to be talking about is activity relative to freezing DB plans. I would just throw open to either of you, probably PBGC in particular, do we have a data capture mechanism knowing when a plan has been frozen?

Mr. KANDARIAN. We know when a plan terminates, Mr. Pomeroy, but we don't know when a plan is frozen because the plan is still outstanding.

Mr. POMEROY. If I was an employer, terminate a plan, you arrive at a termination liability, and there are obviously cost consequences relative to that. Freezing it abates some of that reconciliation of account owed. So, actually there is a financial incentive perhaps to freezing as opposed to terminating.

Mr. KANDARIAN. Right. Since the eighties, 97,000 plans have actually terminated. About 95,000 went to the group annuity market and bought annuities to take care of those obligations.

About 1,800 of those plans came into us because they were underfunded and the plan sponsor couldn't——

Mr. POMEROY. Those are the terminated ones?

Mr. KANDARIAN. Yes.

Mr. POMEROY. My point is I am afraid there is an even greater number being frozen, and my concern is that in this atmosphere of uncertainty, with very considerable potential exposure to the employers, we are driving that number even higher. It would seem to me we ought to find a way to capture data on the plans that are being frozen because that clearly has a significant impact in terms of the retirement savings future of this country. Any ideas within the administration relative to that idea?

Mr. KANDARIAN. We have no mechanism today to gather that information, to require that information to come to us, but we can certainly take a look and see if there is something we could propose.

Mr. POMEROY. I certainly don't want to burden employers. It would seem to me it is pretty important information, especially for those of us attempting to sort out public policy consequences. If they are freezing and we don't know about it, we ought to know about it.

Mr. KANDARIAN. Typically, the plans that are frozen are plans covering salaried workers, because the union plans require a collective bargaining agreement to freeze the plan, and that typically is not provided in those bargaining plans.

Mr. POMEROY. Well, in other words, it looks like—I see that they will quickly—only in organized union collective bargaining agreements will be the last place you have pensions anymore, and I find that terribly regrettable.

It seems to me the approach you indicate a preference for Mr. Secretary, on the yield curve as the basis for how we are going to calculate this would fall disproportionately heavily on struggling industries, steel, airline industries. They are in some of the worst financial shape and creating a lot of concern to their future viability in the marketplace. Do you find critical flaws in the 30-year—I don't propose that Portman-Cardin got it just right, but do you really find it fatally flawed? Isn't it beneficial to the yield curve plan in that it does not fall quite as hard on these industries that are already in wobbly condition?

Mr. FISHER. Let me first try to address the first component there of these hard-hit industries. I think that one of the difficulties I would like to focus on is the fact that the capital markets through their regular accounting are aware of some of the big liability holes where they have the underfunding. Then we end up with a lot of confusion, because over here in this world, as opposed to the SEC accounting world, we have a different measure of the liability, and so I don't think—I think the full weight of that measure of the liability, the one that comes from the cash flow analysis, is already burdening these companies in the sense that its investors are aware of it.

I think we can actually do a great service to those companies that are struggling by coming to an agreement on accurate measures and not confusing the capital market with different measures. If we come to an agreement on accurate measures, then I want to repeat what I have said before and how important it will be to think hard about funding rules and transition rules. I think the companies that are hard hit today need transition rule relief. I don't think we should use the measurement of the liability as a vehicle for what should be transition relief.

Mr. POMEROY. Now, do you anticipate transition relief as an accounting and measurement issue or transition relief in terms of changing the format of the retirement?

Mr. FISHER. As part of the funding rules to work our way out of this, we look at funding rules and transition rules as part of the reform. We have to begin with accurate measures, and I actually think that if we get to, in this world, as accurate a measure as we can over here, that it comports with what the financial markets are looking at, and then we work as hard as we can on the funding and the transition rules together, we will reduce the burden on those companies by removing the uncertainty that overhangs their share price of not knowing what the funding path is going to be.

The current rules create great volatility in the funding requirements of companies. That is the existing regime, and that is part of what I would like us to ultimately be getting at.

Mr. POMEROY. What you say there makes sense to me. I just wish we were further along in terms of having a product. I really do believe it is imperative we do.

Mr. FISHER. Sir, I want to assure you I am also frustrated by how far along we are, and I want to assure you we will work expeditiously with staff here on the Hill in this matter. The 2-year extension is not for us, it is for the industry and the plan sponsors. We are ready to go to work tomorrow and next week immediately on these issues, as we have for many months, and I apologize that you were frustrated by our lack of response. Please let me just ask for your forgiveness.

Chairman MCCRERY. [Presiding.] Thank you, gentlemen, for your testimony.

I would like to call the second panel now. Norman P. Stein, on behalf of the Pension Rights Center, Douglas Arant Professor of Law, University of Alabama; Mr. Kenneth Porter, on behalf of the American Benefits Council—Mr. Porter is Director of the Corporate Insurance and Global Benefits Financial Planning, the DuPont Co.; and Ron Gebhardtsbauer, Senior Pension Fellow at the American Academy of Actuaries.

While they are taking their seats, I would like to recognize Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. I would just like to ask unanimous consent to insert into the record a column on—regarding liquidity of the long-term bond by Nicholas Neubauer, if I may.

[The information follows:]

Treasury Should Resume Issuing 30-year Bonds

In October 2001, the U.S. Treasury Department announced a surprise decision to stop issuing 30-year Treasury bonds. Since that time, long-term markets have suffered from a sense of limbo. Investors have been without an alternative risk-free, long-term investment option. Corporations have been without a government-backed benchmark to price their long-term debt. The market-making infrastructure in long-term debt markets has struggled to maintain its vibrancy. Reversing the decision and resuming issuance of 30-year bonds would stimulate the economy and have many other positive benefits. **A return of the 30-year bond would:**

Benefit Taxpayers through prudent debt management

Putting away 30-year money at today's all-time low rates is common sense debt management. Both corporations and individuals are taking advantage of the current low rates; companies such as Citigroup, Goldman Sachs, Boeing and S.C. Johnson recently issued 30-year bonds, and individuals are refinancing 30-year mortgages at record rates. As *Business Week* quotes Standard & Poors' Chief Economist in the attached commentary: "The U.S. Treasury should be at least as smart as homeowners." At the time the Treasury announced the elimination of the long bond, it optimistically predicted that the Federal government would see a relatively quick return to surpluses. Unfortunately, today's estimates show that will not be the case for some time. While shorter term issues may cost the government slightly less in interest, they will have to be refinanced upon their expiration, quite likely at higher rates. By issuing debt across the entire yield curve, Treasury would best hedge its exposure to whatever kind of interest rate environment the future might bring. With the uncertainty facing our Nation right now, having at least some of the Treasury's debt financed for 30 years at record low rates just makes sense.

Benefit Investors and Corporations

Reissuance would lower risk profiles for long-term investors of all types. Skittish investors looking for secure instruments would have long-term government bonds restored to them as an investment option. Portfolio managers would again have a long-term, risk-free investment vehicle, instead of trying to substitute alternatives issued by concerns less creditworthy than the U.S. Government. Corporations would again have this valuable benchmark to assess the value of long-dated assets and liabilities.

Benefit the U.S. Government by maintaining the vibrancy of long-term markets

Long-term markets are currently operating in a state of limbo, beset by expectations and rumors that the Treasury will ultimately reissue the 30-year bond. With the return of long-term budget deficits, it seems the likely course of action. In the meantime, anecdotal evidence suggests the long-term market is already suffering from reduced liquidity, with market participants complaining of higher costs and erratic price behavior. Unfortunately, the longer the U.S. Treasury goes without issuing the long bond, the more difficult and costly it will be to rebuild the eroding market-making infrastructure to support it.

* * *

In sum, reissuing the 30-year bond would benefit taxpayers, the full range of investors and the U.S. Government by reinstating a long-term, risk-free investment and pricing benchmark, returning to a common-sense debt management policy that issues debt over the entire yield curve, and preserving fully functioning long-term debt and capital markets for the future of U.S. Government debt management.

Chairman MCCRERY. Without objection. Welcome, gentlemen. Your written testimony will be inserted in the record in its entirety, and we invite you now to summarize your testimony in about 5 minutes, and we will begin with Mr. Stein.

STATEMENT OF NORMAN P. STEIN, DOUGLAS ARANT PROFESSOR, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, ALABAMA, ON BEHALF OF THE PENSION RIGHTS CENTER

Mr. STEIN. We would like to be able to substitute a longer document.

Chairman MCCRERY. That is perfectly acceptable. Thank you.

Mr. STEIN. Mr. Chairman, Members of the Subcommittee, I am Norman Stein, a law professor at the University of Alabama, where I am privileged to hold the Douglas Arant professorship and to direct the law school's pension counseling program.

It is also my privilege to appear here today on behalf of the Pension Rights Center, the Nation's only consumer organization dedicated solely to protecting and promoting the pension rights of workers and retirees.

The pension funding issues you are considering today appear to many as hyper-technical matters, primarily of interest to actuaries and accountants and academics and, I guess, Congressmen.

The Subcommittee decision to hold today's hearing, however, underscores the critical relationship between such seemingly technical issues as a 30-year Treasury rate on the one hand and the retirement security of millions of American workers on the other.

My testimony today will focus on two discount rate issues: the proper interest rate for determining plan liabilities for certain statutory funding purposes; and the proper rate for determining lump sum benefit values.

Turning to plan funding, the business community and labor organizations have argued that the use of 30-year Treasury rates currently overstates pension liabilities, artificially causing some plans to appear underfunded, and thus be required to satisfy unnecessarily high minimum funding obligations; but for participants, the key concern in DB plans is benefit security.

Adequate funding levels are a necessary bulwark against underfunded plan terminations and sharp reductions in the benefits and benefit rights of participants in DB plans. In addition, a well-funded pension plan is in a much better position to enhance benefits and provide cost-of-living adjustments to retirees. The 30-year Treasury rate provides a conservative benchmark for plan funding purposes and several actuaries have privately suggested to us that the current 30-year Treasury rate does not greatly overstate pension liabilities.

Nevertheless, we are not unsympathetic to the arguments of the business community that the 30-year Treasury rates may be too low for valuing liabilities in many plans. We thus urge this Congress to proceed conservatively, lest we find as the baby boomers begin retiring in substantial numbers a decade from now that the private pension system is asset short because of decisions about funding standards made precipitously this year.

Some in the business community have advocated a replacement rate as high as 105 percent of the long-term corporate bond rate. The choice of such a benchmark, however, would to a large extent be arbitrary and arguably would have no sounder theoretical grounding than the 30-year Treasury rate in use today. If the latter overstates liabilities in a manner detrimental to plan sponsor flexibility, the former may well understate liabilities and result in an era of plans unable to satisfy benefit commitments.

We do not come here today with a recommendation for a specific replacement rate but believe that an index that tracks annuity purchase rates should be the Committee's target. The corporate bond rate, we believe, is not the best surrogate for this target.

Turning to lump sums, the 30-year Treasury rate is also used for determining lump sum values for annuity benefits. Two related arguments are made for changing the rate here. First, that the required lump sum values are higher than the actual annuity values and thus bleed plans of resources; and second, that the higher lump sum values discourage participants from taking annuities, which subjects them to challenging money management problems in retirement.

The Pension Rights Center has never been an advocate of lump sum payment options, but the reality is that once plans do offer such options, employees rely on the availability of lump sums. Moreover, lump sums are not always an option. Plans are permitted to cash out on a mandatory basis participants whose benefits have a present value of $5,000 or less.

It does not logically follow that the same rate that is used for certain plan funding purposes should also be used to value lump sums. Participants cannot be expected to achieve the same rates of return that are reflected in annuity purchase rates, assuming an equivalent level of risk. This is especially true for employees who receive small lump sum values in mandatory cash-out situations.

We are also skeptical that the 30-year Treasury rate is the primary reason employees who have a choice of benefit form elect to take lump sums. In our experience, employees elect lump sums because they do not wish to leave a former employer in control of their retirement wealth. If Congress wishes to discourage the practice of lump sums, there are far more effective ways of doing so than altering the interest rate used to value them, which in our view would be akin to trying to melt a glacier with a bic lighter.

Thus, in general, we favor a more conservative interest rate for valuation of lump sums than for plan funding purposes, and especially so with respect to employees who are mandatorily cashed out by a plan.

We are also concerned that any change in the interest rates used to determine lump sum values not affect the benefit expectations of current participations. At a minimum, any change should apply only to benefit accruals occurring after the effective date of the change in the section 417(e) interest rate. In addition, there should be a lengthy grandfathering provision period so as not to defeat the reasonable expectations of those close to retirement.

Finally, we would also like to suggest the Committee consider the desirability of some sort of smoothing of whatever rate is elected for valuing benefit options. At present, a sudden change in interest rate immediately before a participant's retirement or earlier separation from service can have a dramatic effect on the value of the participant's lump sum. Smoothing would cushion the participant from the effects of rate volatility and facilitate more effective planning for retirement.

Thank you.

[The prepared statement of Mr. Stein follows:]

Statement of Norman P. Stein, Douglas Arant Professor, University of Alabama School of Law, Tuscaloosa, Alabama, on behalf of the Pension Rights Center

Mr. Chairman, Members of the Subcommittee, I am Norman Stein, a professor at the University of Alabama School of Law, where I am privileged to hold the Douglas Arant Professorship and to direct the law school's pension counseling program, which has helped hundreds of individuals with their pension problems.

It is also my privilege to appear here today on behalf of the Pension Rights Center, the nation's only consumer organization dedicated solely to protecting and promoting the pension rights of workers, retirees and their families.

The issues you are to discuss today, pension funding and particularly the continued appropriateness of the 30-year Treasury rate for various statutory purposes appear to many as hyper-technical matters, primarily of interest to actuaries and accountants and academics. The Subcommittee's decision to hold a hearing on this issue alone, however, underscores the critical relationship between such seemingly technical issues, on the one hand, and the retirement security of millions of American workers, on the other. As you have heard from representatives of the business community, these technical issues also bear heavily on the financial health of many industries and individual companies.

My testimony today will focus separately on two issues: the proper discount rate for determining plan liabilities for certain statutory funding and PBGC purposes; and the commutation of annuity benefits into lump sum benefit amounts. In my comments, I will allude to some other funding issues, but will concentrate on alternatives to the 30-year Treasury rates for these two purposes.

Plan Funding. The business community and labor organizations have argued that the use of 30-year Treasury rates currently overstates pension liabilities, artificially causing some plans to appear underfunded and to satisfy unnecessarily high minimum funding obligations.

Benefit security is a key concern for participants in defined benefit plans. Adequate funding levels are a necessary bulwark against unfunded plan terminations and sharp reductions in the benefits and benefit rights of participants in defined benefit plans. At the Alabama Pension Clinic we counsel clients who know first-hand the devastating consequences of underfunding. They, like the USAirways pilots and Bethlehem Steel retirees who recently made headlines, lost thousands of critical pension dollars because their benefits were only partly guaranteed when their plans terminated. In addition, a well-funded pension plan is in a much better position to enhance benefits and provide COLAs for retirees. The 30-year Treasury rate provides a conservative benchmark for plan funding purposes and at least some actuaries have privately suggested to us that the current 30-year Treasury rate does not greatly overstate pension liabilities, at least for determining whether a plan is underfunded for certain statutory purposes. (This is particularly true given that some funding rules, viewed in isolation, can be seen as permitting a firm to underfund a plan in certain situations.)

We are, however, sympathetic to the arguments of the business community that the 30-year Treasury rate is somewhat too low for valuing liabilities in most plans. In determining a replacement rate, however, we urge that this Congress proceed conservatively, lest we find as the baby boomers begin retiring in substantial numbers a decade from now, that the private pension system is asset-short because of decisions about funding standards made precipitously years earlier.

The business community has advocated a replacement rate equal to as much as 105% of a composite high-quality, long-term corporate bond rate. The choice of such a rate is, however, to a large extent arbitrary and arguably has no sounder theoretical grounding than the 30-year Treasury rate. If the latter overstates liabilities in a manner detrimental to plan sponsor flexibility, the former may well understate liabilities and may result in an era of plans unable to satisfy benefit commitments.

We do not come here with a recommendation for a replacement rate, but believe that an index that more closely tracks annuity purchase rates should be the committee's target. The corporate bond rate misses this target.

Determining Lump Sum Values. The 30-year Treasury rate is also used for determining lump sum values for annuity benefits in defined benefit plans that provide for a lump sum distribution option. Two related arguments are made for changing this rate: first, that the lump sum values are higher than the annuity values and thus bleed plans of resources; and second, that the higher lump sum values encourage participants to take annuities, which subjects them to challenging money management problems in retirement.

The Pension Rights Center has never been an advocate of lump sum payment options—annuity payouts provide far greater security for both retirees and their spouses. But the reality is that once plans do offer such options, employees rely on the availability of lump sums. Moreover, lump sums are not always an option. Plans are permitted to cash out, on a mandatory basis, participants whose annuity benefits have a present value of $5,000 or less.

It does not logically follow that the same rate that is used for certain plan funding purposes should also be used to value lump sums. Participants cannot be expected to achieve the same rates of return that are reflected in annuity purchase rates or a composite bond rate. This is especially true for employees who receive small lump sum values in mandatory cashout situations. Moreover, reduction of lump sum values in this situation will make it less likely that a former employee will rollover their lump sum into an individual retirement account and thus preserve the benefits for retirement.

We are also skeptical that the 30-year Treasury rate is the primary reason employees who have a choice of benefit form elect to take lump sums. In general, they elect lump sums because they do not wish to leave a former employer in control of their retirement wealth. If Congress wishes to discourage the practice of lump sums, there are far more effective means of doing so then altering the interest rate used to value them. This is akin to trying to melt a glacier with a bic lighter.

Thus, in general, we would favor a much more conservative interest rate for valuation of lump sums than for plan funding and other statutory purposes, and especially so with respect to employees who are mandatorily cashed out by a plan.

We are also concerned that any change in the interest rates used to determine lump sum values not effect the benefit expectations of current participants. At a minimum, any change should apply only to benefit accruals occurring after the effective date of a change in the section 417(e) interest rates. In addition, there should be a grandfathering provision for those within five years of retirement, so as not to defeat their reasonable expectations.

We also would like to suggest that the Committee consider the desirability of some sort of smoothing of whatever rate is used for valuing benefit options. At present, a sudden change in interest rate immediately before a participant's retirement or earlier separation from service can have a dramatic effect on the value of a participant's lump sum. Smoothing would cushion the participant from the effects of rate volatility and facilitate more effective planning for retirement.

Thank you. I would be happy to take any questions.

Mr. MCCRERY. Thank you, Mr. Stein. Mr. Porter.

STATEMENT OF KENNETH PORTER, DIRECTOR, CORPORATE INSURANCE & GLOBAL BENEFITS FINANCIAL PLANNING, DUPONT COMPANY, WILMINGTON, DELAWARE, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL

Mr. PORTER. Chairman McCrery and Congressman McNulty, thank you very much for the opportunity to appear today. I am Ken Porter, director of Corporate Insurance and Global Benefits Financial Planning for the DuPont Company. DuPont has 79,000 employees worldwide and delivers science-based solutions to such areas as food and nutrition, health care, construction, and transportation.

I appear today on behalf of the American Benefits Council where DuPont and I personally serve on the board of directors. The American Benefits Council is a public policy organization principally representing Fortune 500 companies and other organizations that either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

Like you, the Council Members are concerned about the health of the voluntary DB employer-sponsored plans in the United States. We have heard about the numbers and the decline of the number of plans in recent years and the freezing of plans. We are very troubled by this. Companies that sponsor these plans need stability.

I personally in my company have a plan that has been overfunded for 18 years, been over the full funding limit. We have not been permitted to make tax-deductible contributions. This year for the first time that has changed.

Our rating agencies that set our credit ratings are demanding 4-year or 5-year cash flow analyses now that we might have funding opportunities, and I can't tell them what that is because I don't know what the law is going to be. I can deal with the uncertainty of the investment markets better than I can the uncertainty of the law. Rating agencies don't understand why I can't tell them what a 5-year forecast of cash flow is. I am in an urgent need for a permanent solution.

In this regard, the Council is extremely pleased that a permanent reform has now been introduced by Representatives Portman and Cardin as part of H.R. 1776. We wish to sincerely thank them for the many months of hard work and deliberation that has led to the introduction of this bipartisan proposal. They have once again forward with a balanced solution to a complex and pressing pension problem.

The Portman-Cardin proposal permanently replaces the 30-year Treasury bond rate with a rate of interest earned on conservative long-term corporate bonds. It directs the Department of Treasury to produce this rate based on one or more corporate bond indices. On balance, it is just a conservative middle-road rate that is somewhere between what corporations can actually earn on their investments in an ongoing pension plan and what insurance companies charge companies for then terminating pension plans.

The Council is gratified that the Portman-Cardin proposal embraces a number of the principles of reform that the Council has developed. First, the proposal is both permanent and comprehensive covering funding premiums and lump sum calculations. Second, it applies a consistent rate for the various pension calculations. Third, it is a blend of stable long-term corporate bond rates that is new and more rational benchmarking for measuring liabilities. Fourth, it provides a strong existing set of rules that provide the stability that employers need in order to be able to get the credit ratings and the debt support that they need in this economy.

So, in concluding, as you have heard, the Department of Treasury is advocating an alternative approach. This approach is not analyzed. It hasn't been developed. We don't know exactly what it is. What we do know is it provides a level of uncertainty, and we need some stability. It uses an interest rate to measure liability associated with the duration of time till benefits are paid out.

We have serious concerns with this approach. First, a yield curve will significantly increase the volatility and complexity of pension funding as we understand it. More importantly, because it hasn't been tested and hasn't been vetted, we don't know what it is. It is unclear how the concept would apply to issues as it relates to calculation of lump sums. It is unclear how it would apply to employees' contributions to pension plans and the payment of credits under hybrid pension plans. It is likewise unclear what sort of transition approach would be adopted from the current system.

Accordingly, if we look at the experience of the United Kingdom as an example, where an accounting standard was adopted that required this kind of an analysis, we have concern that there could be unintended negative impacts on the investment markets, the economy, and the Federal deficit. Some may wish to debate the theoretical merits of the yield curve concept, and if in fact that is the decision to debate that, we would love as a Council to participate in that debate, but there is an urgent need for us to permanently replace the 30-year Treasury rate, and it can't wait for an academic discussion. It needs to move now.

Mr. Chairman, DB plans offer many unique retirement advantages. The employer community and the sponsors of these programs are very interested in their continuation. They are very concerned in perpetuating plans, to provide security to our employees, but without prompt action by Congress to replace the obsolete 30-year Treasury rate, we fear that these plans will increasingly disappear from the American landscape.

Thank you.

[The prepared statement of Mr. Porter follows:]

Statement of Kenneth Porter, Director, Corporate Insurance & Global Benefits Financial Planning, DuPont Company, Wilmington, Delaware, on behalf of the American Benefits Council

Chairman MCCRERY., Ranking Member McNulty, I thank you for the opportunity to appear today on this critically important topic. I am Ken Porter, Director of Corporate Insurance & Global Benefits Financial Planning for the DuPont Company. DuPont is a company with 79,000 employees worldwide that delivers science-based solutions in such areas as food and nutrition, health care, apparel, safety and security, construction, electronics and transportation.

I am appearing today on behalf of the American Benefits Council, where DuPont serves on the board of directors. The American Benefits Council (Council) is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

Like you, Mr. Chairman, the Council and its member companies are very concerned about the health of the voluntary, employer-sponsored defined benefit pension system. The largest problem today for defined benefit plans is the required use of an obsolete interest rate for pension funding, pension premium and lump sum distribution calculations. Use of this obsolete benchmark—the rate on 30-year Treasury bonds—artificially inflates a plan's liabilities and required contributions that competes for limited cash the sponsoring employers need for capital improvements that create jobs, and threatens employers' ability to continue their commitment to defined benefit programs for their employees. The effects of this interest rate anomaly are exacerbated by the current economic and stock market downturn, which have dramatically reduced plan asset levels.

Fortunately, Congress can address many of these challenges in a positive manner that will enable employers to provide financially sound pension programs. Our testimony today details the current threats and opportunities. After providing some background on the defined benefit system and the current state of pension funding, we discuss the urgent need to replace the 30-year Treasury bond rate through prompt enactment of the provision included in the Pension Preservation and Savings Expansion Act (H.R. 1776), which was recently introduced by Representatives Portman and Cardin. We then discuss several other policy priorities for the defined benefit system and conclude by providing our perspective on the current financial position of the Pension Benefit Guaranty Corporation (PBGC).

Background on Defined Benefit Plans

While the defined benefit system helps millions of Americans achieve retirement income security, it is a system in which fewer and fewer employers participate. The total number of defined benefit plans has decreased from a high of 170,000 in 1985 to 56,405 in 1998 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today.[1] There has been a corresponding decline in the percentage of American workers with a defined benefit plan as their primary retirement plan from 38% in 1980 to 21% in 1997. Looking at this decline over just the past several years makes this unfortunate downward trend all the more stark. The PBGC reports that it insured 39,882 defined benefit plans in 1999 but only 32,321 plans in 2002. This is a decrease of over seven thousand, five hundred defined benefit plans in just three years.

These numbers reflect the unfortunate reality that today's environment is so challenging that more and more employers are concluding that they must terminate their pension programs. Even more disheartening, the statistics quoted above do not even take into account pension plans that have been frozen by employers (rather than terminated), an event that, like termination, results in no additional accruals for existing employees and no pension benefits whatsoever for new hires. If frozen plans were tracked, the tragic decline of our nation's defined benefit pension system would be even more apparent.

These numbers are sobering from a human and policy perspective because defined benefit plans offer a number of security features critical for employees' retirement security—benefits are funded by the employer (and do not typically depend upon employees making their own contributions to the plan), employers bear the investment risk in ensuring that earned benefits are paid, benefits are guaranteed by the federal government through the PBGC, and benefits are offered in the form of a life annuity assuring that participants and their spouses will not outlive their retirement income. The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances) have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

So, with these advantages for employees, what has led to the decline of the defined benefit system? We see several factors that have played a role. First, we see a less than friendly statutory and regulatory environment for defined benefit plans and the companies that sponsor them. Throughout the 1980's and early 1990's, frequent changes were made to the statutes and regulations governing defined benefit pensions, often in the name of promoting pension "fairness." The primary driver behind these changes was a desire to eliminate potential abuses attributed to small employer pension plans. And yet, these rules were applied across the board to employers of every size. The result was that defined benefit pension plans became increasingly expensive and complicated to administer and plan funding and design flexibility was impaired. During this same period, Congress repeatedly reduced the benefits that could be earned and paid from defined benefit plans in order to increase federal tax revenues, thus significantly reducing the utility of these voluntary plans to senior management and other key decision-makers. Moreover, many companies have found the cost of maintaining a defined benefit plan more difficult in light of intense business competition from domestic and international competitors, many of which do not offer defined benefit plans to their employees and so do not have the corresponding pension expense.

Perspective on Pension Plan Funding

The deterioration in the funding status of many defined benefit plans is, as has been discussed today, attributable in large measure to the unique combination of historically depressed asset values and historically low interest rates. And indeed, the statistics on plan funding levels can appear bleak.[2] Yet we must maintain the proper perspective in evaluating the significance of today's numbers. First, we must recognize that many current measures of funded status use the obsolete 30-year Treasury bond rate to value liabilities. This low and discontinued rate makes plan liabilities seem larger than they really are and consequently makes a plan's funding level seem more dire than it really is. When coupled with the current abnormally low interest rate environment, use of an obsolete Treasury bond rate is punitive to

[1] The decline in sponsorship of defined benefit plans is in stark contrast to the increase in sponsorship of defined contribution plans, such as 401(k)s. According to the same official Department of Labor statistics, the number of defined contribution plans has increased from 462,000 in 1985 to 661,000 in 1997.

[2] A January 2003 report from a national consulting firm found that the pension benefit obligation funded ratio—the ratio of market value of assets to pension benefit obligations for a benchmark plan—is near its lowest point in 13 years. *Capital Market Update*, Towers Perrin, January 2003.

America's retirement system. Second, we must remember that looking at a pension plan's funding level at a specific point in time is a very misleading indicator of the plan's ultimate ability to pay out participant benefits.

Finally, it is important to note that the swing from the abundant pension funding levels of the 1990s to the present state of increasing deficits for many plans is due in significant measure to the counterproductive pension funding rules adopted by Congress. Over the nearly 30 years since the enactment of the Employee Retirement Income Security Act (ERISA), Congress has alternated between strengthening the pension plan system and limiting the revenue loss from tax-deductible pension contributions. Beginning in 1986, Congress limited the ability of companies to contribute to their plans by lowering the maximum deductible contribution and imposing a heavy excise tax on nondeductible contributions. In 1997 and after, some relief was provided, but the overall result is that our laws and regulations strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level.[3] By 1995, only 18 percent of plans had a funded ratio of assets over accrued liabilities of 150 percent or more as compared with 45 percent in 1990.[4]

Pension Interest Rate Reform

Clearly the action most urgently needed to improve the health of the defined benefit system and stem the increasing number of defined benefit plan freezes and terminations is for Congress to enact a permanent replacement for the 30-year Treasury bond rate currently used for pension calculations.

Under current law, employers that sponsor defined benefit pension plans are required to use 30-year Treasury bond rates for a wide variety of pension calculations. Yet the Treasury Department's buyback program and subsequent discontinuation of the 30-year bond has driven rates on these bonds to a level significantly below other conservative long-term bond rates. The result has been an artificial inflation in pension liabilities, often by more than 20 percent. As a result of these inflated liabilities, employers confront inflated required pension contributions and inflated variable premium payments to the PBGC. Due to the nature of the pension funding rules—where required contributions do not increase proportionally with increases in liabilities and decreases in funded levels—a number of employers have been confronting dramatic increases in their pension funding obligations. These inflated required contributions divert corporate assets urgently needed to grow companies and payrolls and return the nation to robust economic growth.[5]

Even historically robustly funded pension plans may now be faced with voluntary or mandatory contributions. Under current law, when a plan comes out of full funding, voluntary actions taken in 2003 may affect mandatory contributions in 2004 and 2005. The uncertainty in provisions of law related to pension funding rules can be more daunting than the uncertainty of future investment markets. Without immediate change in the law, it is impossible for even these historically well-funded plans to estimate the appropriate 2003 voluntary actions that may be appropriate for longer-term cash flow management.

The low 30-year Treasury bond rates have the same inflationary effect on lump sum payments from defined benefit plans. In other words, the low 30-year bond rates have produced artificially inflated lump sum payments to departing employees. While these inflated lump sums may appear to redound to the benefit of workers, the reality is that the drain of cash from plans as a result of these artificially inflated payments jeopardizes the financial position of the plan and undermines the ability of the employer to continue providing benefits to current and future employees. Artificially inflated lump sums also deter employees from taking benefits in an annuity form of payment, with the protections such form offers against spousal poverty and outliving one's financial resources. Plans with lump sum payouts as an option report nearly 100 percent of retiring participants elect the lump sum option because they perceive lump sums as extremely favorable when compared to the promise of a lifetime income guarantee. The cold reality is that departing employees are taking a benefit payment that is far greater than what the plan had been expected

[3] The Council strongly supports review and re-evaluation of the basic funding rules that prevent employers from funding their plans generously when economic times are good and then impose draconian funding obligations when economic times are bad.

[4] Table 11.2, *EBRI Databook on Employee Benefits*, 1997, 4th Edition, The Employee Benefits Research Institute, Washington, D.C.

[5] Concurrently, these inflated contributions may contribute significantly to the growing federal budget deficit. Plan contributions are deductible under the Internal Revenue Code, and to the extent that funds used for contributions are not available for other, nondeductible investments or do not represent income to the corporation, they would be lost as revenue for federal budget purposes.

to pay. The resulting unexpected costs increase the visibility of pension expense within corporate budgets and contribute to the determination by many that defined benefit pension programs are unsupportable.

The various financial ramifications of the low 30-year bond rate—funding, premiums, lump sums—have been a key factor underlying the recent increase in the number of employers freezing their defined benefit plans. Across a range of industries—from health care to manufacturing to transportation—we at the Council have seen a marked increase in freezes over the past 12 months with many more employers currently considering taking this step. This has disastrous results for employees. Those working for the employer receive no newdefined benefit pension benefits for the remainder of their service. And those not yet hired will have no opportunity to build a defined benefit pension benefit. In a world where employees already shoulder significant exposure to stock market volatility and retirement income risk through defined contribution plans and personal savings vehicles, these pension freezes and the corresponding loss of retirement security are a dire development for American workers and their families.

Recognizing the importance of stemming this tide, Congress enacted short-term interest rate relief for funding and premium purposes in the Job Creation and Worker Assistance Act of 2002. The Council wishes to thank the members of this Subcommittee for providing this short-term but quite meaningful relief. This relief, however, was not comprehensive in nature and expires at the end of this year. It is therefore imperative for Congress to enact permanent and comprehensive pension interest rate reform as soon as possible.

The Council is extremely pleased that a proposal for such reform has now been introduced by Representatives Portman and Cardin as part of their Pension Preservation and Savings Expansion Act of 2003 (H.R. 1776). We wish to sincerely thank Representatives Portman and Cardin for the many months of hard work and careful deliberation that led to introduction of this bipartisan proposal. They have once again come forward with a balanced and critically needed solution to a complex and pressing pension problem.

The Portman/Cardin proposal permanently replaces the 30-year Treasury bond rate with the rate of interest earned on conservative long-term corporate bonds, directing the Treasury Department to produce this rate based on one or more corporate bond indices. This use of a corporate bond rate blend steers a conservative middle course between the rates of return actually earned by pension plans and the annuity rates charged by insurers to terminating plans. This new rate would apply for all pension calculation purposes, including funding, PBGC premiums and lump sums.

The Council has been advocating permanent replacement of the 30-year bond rate for several years and we are gratified that the Portman/Cardin proposal embraces a number of the principles for reform that we have set forth. First, their proposal is both permanent and comprehensive.[6] Second, their proposal uses a consistent rate for pension calculations rather than using differing rates for funding and lump sums (which could create severe financial instability in plans). Third, the proposal looks to a blend of stable, long-term corporate bond indices as the basis for the new interest rate benchmark. Fourth, the proposal maintains existing interest rate averaging mechanisms and corridors, recognizing that the rate replacement task is too important to be held up by debates over the possible wisdom of structural reform.

We cannot over-emphasize the urgency of enacting the permanent, comprehensive reform contained in H.R. 1776 nor the degree to which achieving this reform is related to stemming the decline in defined benefit plans. Action is needed by late spring in order to convince employers currently struggling with the difficult decision of whether to freeze or terminate their plans that help is on the way. Uncertainty about the future interest rate is also contributing to stock price instability as companies cannot accurately predict their future pension liabilities and costs. Stock market analysts have even begun to downgrade the stocks of firms with significant defined benefit plans in light of this uncertainty while credit rating agencies have recently been citing the size of retiree benefits obligations as grounds to change plan

[6] While the Council is pleased that as part of this comprehensive approach H.R. 1776 applies the new interest rate to lump sum calculations, we are concerned about the significant delay before application of the corporate bond rate to lump sums takes effect. We understand the need to provide a transition period to address the concerns of workers on the verge of retiring and taking lump sums, but we are concerned that the two-year delay in application of the lump sum rate change followed by the 5-year transition from the 30-year rate to the corporate bond rate simply postpones the necessary shift for too long. With the full change in interest rate for lump sums not taking effect until 2010, employers will continue to see employees taking inflated lump sums for many years, with the corresponding harmful effect on plan funding and employers' ability to maintain benefit levels and potentially the plan itself.

sponsors' credit ratings, place them on credit watch, or issue statements of negative outlook. Finally, the correction of inflated pension financing obligations will allow companies to devote resources to growing their businesses and the economy.

To address these uncertainties and the truly negative ramifications for pension plan participants, employer sponsors, equity markets and indeed our economy as a whole, we urge Congress to enact the Portman/Cardin proposal in H.R. 1776 as part of the first possible legislative vehicle being sent to the President. In this regard, we urge the inclusion of the proposal in the economic growth legislation that the Ways & Means Committee will soon craft.[7] Without enactment of permanent and comprehensive reform this spring, the harm to our nation's defined benefit pension system—and the millions of American families that depend on this system for retirement income—will be irreparable.

Before leaving the issue of pension interest rate reform, let me briefly discuss an alternative approach to replacing the 30-year rate that has been discussed by some and is currently under review by the Treasury Department. This approach would be to use a corporate bond yield curve as the new interest rate benchmark for valuing pension plan liabilities. Under this yield curve concept, the interest rate used for measuring the liability associated with a particular pension plan participant would be the interest rate on a bond with a duration equal to the period prior to the retirement date of that participant.

The Council has a number of very significant concerns about a yield curve approach.[8] But perhaps the most serious threshold problem is that a yield curve concept is just that—a concept, an idea—and one that is highly controversial at that. It is not a formulated proposal for replacing the 30-year Treasury bond rate. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest and conversion to annuities of employee contributions to defined benefit plans, and the payment of interest credits under hybrid pension plans. It is likewise unclear what sort of transition approach would be adopted to move from the current system of reliance on a single duration rate to a much more complex system that relies on a multiplicity of instruments with differing durations and rates. Some may wish to debate the theoretical merits of the yield curve concept and/or explore the many unanswered questions such a concept presents—indeed the Council would be happy to be a part of such discussions. But the urgent need to replace the 30-year rate cannot await such academic deliberations. Plans and benefits are being frozen *today* and a replacement for the obsolete 30-year rate must likewise be enacted *today*.

Additional Defined Benefit Issues of Importance

While replacement of the 30-year Treasury rate is clearly the most urgent policy priority for today's defined benefit pension system, the Council wishes to draw the

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[7] It is anticipated that the interest rate reform proposal contained in H.R. 1776 may actually generate tax revenue and so would not divert resources from other elements of the economic growth package.

[8] First, a yield curve approach to measuring pension plan liabilities would increase the volatility of these liabilities. Liabilities would become dependent not only on fluctuations in interest rates but also on changes in the shape of the yield curve (which occur when the rates on bonds of different durations move independent of one another) and on changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, divestitures, etc.). In addition, proponents of a yield curve concept have generally frowned on the so-called smoothing techniques embodied in present law, which allow employers to use the average of the relevant interest rate over several years in valuing liabilities. Reduction or elimination of smoothing would further increase volatility. Yet volatility in pension obligations undermines employers' ability to predict and budget their costs and has already been one significant deterrent under current law to remaining in the defined benefit system. Clearly it would be counterproductive to aggravate this deterrent in a proposal designed to improve the health of the defined benefit system. Second, the markets for bonds of certain durations that would be utilized under a yield curve concept are very thin, with few such bonds being issued. As a result, single events—the bankruptcy of a single company unrelated to the plan sponsor, for example—can affect the rate of a given bond index dramatically and further aggravate the volatility of pension liability measurements. Third, a yield curve approach would be significantly more complex than the current system. As a result, it will be much more difficult to explain to employer sponsors of plans, many of which already see the complexity of the system as a reason to abandon their defined benefit programs. For large employers with multiple defined benefit plans, complexity will be further increased since each plan will be required to use a different rate for measurement of its liabilities (since the duration of liabilities in each plan will differ). The complexity of the approach will also mean that employers must rely more heavily on sophisticated actuarial and software services, driving up the costs in an already expensive pension system. Such increased costs are detrimental to all employers but can be particularly daunting to small and mid-size employers where pension coverage rates are the lowest.

Subcommittee's attention to a number of additional issues of importance confronting the defined benefit system.

- **Making the 2001 Pension Reforms Permanent.** The 2001 tax act contained a number of very positive changes to the rules governing defined benefit plans, which originated in previous Portman/Cardin pension bills. These included repeal of artificial funding caps, increases in the benefits that can be paid and earned from defined benefit plans, and simplifications to a number of defined benefit plan regulations. We strongly urge Congress to make these and the other 2001 retirement savings reforms, which are scheduled to sunset at the end of 2010, permanent so that employees and employers can have the long-term certainty so necessary for retirement planning.
- **The Next Generation of Defined Benefit Plan Reform.** In addition to the 30-year bond rate replacement, the latest Portman/Cardin pension bill (H.R. 1776) contains a number of improvements to the defined benefit system. These reforms would help retirees use their pension payments to finance retiree health or long-term care coverage on a pre-tax basis, would address impediments in the defined benefit plan deduction and funding rules, and would further streamline defined benefit plan regulation. We urge Congress to enact these changes at the earliest opportunity.
- **Hybrid Plans.** Pending at the regulatory agencies are several projects to provide needed guidance regarding hybrid pension plans such as cash balance. These hybrid plans maintain defined benefit security guarantees while providing the transparency, individual accounts and portability that employees prefer. They have been a rare source of vitality within our defined benefit system. We urge Congress to allow the pending regulatory projects to proceed and to reject bills (such as H.R. 1677) that would override these efforts and impose unsupportable mandates on pension plan sponsors.
- **Pension Accounting.** Finally, the Council wishes to alert the Subcommittee to some ominous developments concerning the accounting standards for pension plans. Accounting standard-setters, led by those in the United Kingdom, are pushing to require companies to reflect the full fluctuation in pension asset gains and losses on the firm's financial statements each year, thereby prohibiting companies from amortizing such results over a period of years as they do under today's accounting standards. This new 'mark-to-market' approach is inconsistent with the long-term nature of pension obligations, produces extreme volatility in annual corporate income, and has prompted 75% of British pension sponsors to consider terminating their plans. Given the many other challenges faced by sponsors of defined benefit plans, abandonment of current U.S. accounting standards for this 'mark-to-market' approach would be devastating.

Financial Status of the Pension Benefit Guaranty Corporation

Given the discussion today about the financial condition of the PBGC, let me provide our perspective on this situation. I want to underscore that the Council has always predominantly represented companies with very well-funded plans. Indeed, the Council has been at the forefront of past Congressional efforts promoting strong funding standards to ensure that the weakest plans would not be able to terminate their plans and impose their liabilities on other PBGC premium payers. Simply stated, the Council has no incentive to trivialize any problems at the PBGC that will come back to haunt us if other companies are not able to keep their promises to retirees.

Nonetheless, while the deficit revealed in the PBGC's 2002 annual report is certainly to be considered very seriously, we do not believe it indicates an urgent threat to the PBGC's viability. Indeed, the PBGC operated in a deficit position throughout much of its history. Nor does the shift from surplus to deficit over the course of one year suggest the need to change the pension funding or premium rules in order to safeguard the health of the PBGC. In particular, the Council is unlikely to support any proposal that would unwisely penalize prudent and proven plan asset allocation strategies or firms undergoing short-term financial stress. We note that, as the agency stated in its report, the insurance program's total assets are in excess of $25 billion and it should be able to meet current and expected obligations for years to come. At this point in time, we believe the best way to ensure the agency's financial position is to keep as many employers as possible committed to the defined benefit system. The urgently needed policy changes we are advocating today will help achieve this aim and ensure that the PBGC continues to receive a steady stream of premium income from defined benefit plan sponsors.

Conclusion

Mr. Chairman and Ranking Member McNulty, I want to thank you once again for calling this hearing on what the Council believes are some of the most important retirement policy questions our nation faces. Defined benefit plans offer many unique advantages for employees and the employer sponsors of these programs sincerely believe in their value, but without prompt action by Congress we fear these plans will increasingly disappear from the American pension landscape.

Thank you very much for the opportunity to appear today and I would be pleased to answer whatever questions you and the members of the Subcommittee may have.

Chairman MCCRERY. Thank you, Mr. Porter. Mr. Gebhardtsbauer.

STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES

Mr. GEBHARDTSBAUER. Chairman McCrery, Ranking Member McNulty, and distinguished Members, my name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the professional organization for all actuaries in the United States. My written statement provides more details on this subject so that I can focus on the most important issue for this hearing: the need for a quick permanent fix to the pension discount rate.

The DB plans are beneficial to employees, the Nation and employers. However, many employers are considering freezing or terminating their plans because the temporary fix to the discount rate expires at the end of this year. Meanwhile, major financial decisions are being made today which depend on what next year's pension contribution will be.

Market analysts, board members, and courts are asking can the company afford their pension plan next year. They may decide that the employer cannot afford the pension plan and later find out that the rule was fixed and that the employer could have afforded it. Bad decisions can come from this uncertainty. Thus, a permanent fix is desperately needed and needed very soon.

So, what should this rate be? The Academy's Pension Practice Council suggests that a high-quality corporate bond rate, the blue line of the chart—or annuity pricing rate which is the green line, which is just a little bit lower, or something between those two rates would be appropriate. These color charts are also in the back of your handouts.

Although these rates are only 70 basis points apart, we do not take a position on exactly which rate is the correct one. Rather, Congress is the best-suited place to balance the competing interests of benefit security and employers' ability to maintain the plan. For example, a lower discount rate will improve benefit security and help the PBGC, while a higher discount rate can help benefit adequacy and improve employers' ability to maintain the plan.

In addition, this chart shows a smoother line; you can see the smooth line that we are currently allowed to use for discounting. That is the brown line. You will notice that it has consistently been quite close to the corporate bond line, the blue line, so the rules for a long time have been already at the corporate bond line. Clearly, it has been above the green line, the annuity pricing line. In fact, when the highest permissible rate fell recently, Congress fixed it. As you see, it jumps up and goes back up to the blue line. Congress put it back up where the corporate bond line is, and there are reasons for using a corporate bond rate. For example, the SEC and the Federal Accounting Standards Board both require it for the financial statements.

In addition, if a terminating pension plan is funded to the corporate bond amount, it generally does not need the PBGC because if additional amounts are needed—in other words, if it is slightly underfunded—the employers are more likely to pay that small amount back into the plan and terminate on a standard basis.

Some plans use a slightly different interest rate for their financial statements. They will use a rate from an immunized bond portfolio. In this case even if the employer doesn't make the contribution, PBGC generally does not experience an economic loss even if they take over this pension plan, because PBGC does not guarantee the full benefits in the plan and they do not buy annuities.

Third, another acceptable rate, again that green line, the annuity rate, is the discount rate used by insurance companies to price annuities. It could increase the liabilities over using a bond rate by, say, 6 or 7 percent so you can see where all these rates that we are talking about are pretty close. We are talking on the head of a pin here. Employers may not want to contribute more than they need to. For instance, if they self-insure, just like the PBGC, they don't buy annuities, so that they can avoid paying the profits and the risk margins that an insurance company would charge.

There are many other ideas for keeping DB plans afloat described in my written testimony.

One important idea mentioned earlier by most of the people has been to allow employers to contribute more in the years in which they are healthy. Currently some employers cannot create a margin in their pension plan with a deductible contribution. In fact, if they make that contribution they would have to pay an excise tax immediately and some day they might have to pay a huge reversion tax.

The rule works well when interest rates are high but not when interest rates are low, like right now, particularly for plans that are retiree heavy like hourly plans, which cannot advance fund their benefit increases.

In summary, being forced to contribute when you can least afford it and being kept from contributing when you can afford it is unreasonable and difficult on the PBGC, employers, and participants. So, raising the discount rate soon and allowing the contributions above 100 percent of current liability would resolve these two major problems.

We at the Academy would like to work with you on this, and we thank you for having this hearing and inviting us to speak.

[The prepared statement of Mr. Gebhardtsbauer follows:]

Statement of Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries

Chairman McCrery, Ranking Member McNulty, and distinguished committee members, good afternoon and thank you for inviting us to testify on "The Challenges Facing Pension Plan Funding." My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the non-partisan public policy organization for all actuaries in the United States.

My written statement covers five important issues for this hearing, namely:

(1) Problems of the current funding rules and the need for a quick permanent fix,
(2) Alternatives for discounting liabilities,
(3) Concerns with current lump sum rules,
(4) Pension Benefit Guaranty Corporation (PBGC) issues, and
(5) Allowing greater contributions when employers are able to make them.

Background and Problem: Defined benefit (DB) plans are beneficial to employees, employers, and the nation.[1] However, as you know, a problem in pension funding rules arose in 1998 due to Treasury bond rates becoming inordinately low in comparison to corporate bond rates and annuity prices. As pointed out in our 2001 paper on this subject,[2] the rules' use of 30-year Treasury rates has dramatically increased minimum pension contributions (to levels much higher than Congress ever intended), at a time when employers are seriously constrained financially.

Temporary Fix: Fortunately, Congress acted quickly in March of 2002 to remedy this problem by allowing employers to use a higher discount rate in 2002 and 2003 for determining their pension liabilities and PBGC premiums. However, the pension rules revert back to the low discount rates in 2004. Meanwhile, major financial decisions are being made today, which depend on what next year's pension contribution will be. In addition, bankruptcy judges are being forced to decide today whether employers can afford their pension plans in 2004 and beyond. Courts may decide the employer cannot afford its pension plan, and later find out that the rule had been corrected and the employer could have afforded the pension plan. Bad decisions can come from uncertainty. Thus, a permanent fix is desperately needed for the funding rules quickly. Delaying the fix will continue to allow the bad decisions being made in courts, in board rooms, and on trading floors today that are adverse to the future of our voluntary retirement system.

Selecting an appropriate target: The first step to resolving this issue (and perhaps the most challenging) is to select an appropriate target. Any interest rate alternative should be judged based on the results it produces relative to this target. An appropriate target should:

- Produce contributions that will adequately address participant and PBGC security concerns without forcing ongoing companies to put more assets into their pension plans than needed;
- Encourage the continuation of voluntary plans for the benefit of their participants—which is one of the three stated purposes of ERISA's Title IV (section 4002(a)(2))—and avoid discouraging the formation of defined benefit plans because of overwhelming or unpredictable funding requirements;
- Avoid funding requirements that unnecessarily divert funds that could otherwise go to increasing other benefits and wages, retaining employees, or keeping the company from financial distress; and
- Maintain PBGC premiums at the lowest level consistent with carrying out their obligations per ERISA section 4002(a)(3).

Annuities and/or Lump Sum Values: Congress may have intended the interest rate used in current liability calculations to reflect a plan sponsor's cost of plan termination—the actual cost of annuities and lump sums. In the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), Congress specified that the interest rate used should be "consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan."[3] Note that the law uses the word "liabilities," and not "annuities." Thus, we are not sure why the cost of lump sums should be ignored, as per IRS Notice 90–11. Currently, lump sum amounts can be larger than the respective annuity premiums due to interest rate requirements in IRC section 417(e). We recommend that Notice 90–11 be revised to specify that benefit liabilities equal the lump sum amounts for par-

[1] See our earlier testimony on the advantages of defined benefit plans at the June 20, 2002 hearing of the Ways and Means Subcommittee on Oversight on "Retirement Security and Defined Benefit Pension Plans" at http://www.actuary.org/pdf/pension/testimony_20june02.pdf

[2] See our paper, "The Impact of Inordinately Low 30-Year Treasury Rates on Defined Benefit Plans," which can be found at http://www.actuary.org/pdf/pension/treasurybonds_071101.pdf

[3] Internal Revenue Code (IRC) section 412(b)(5)(B)(iii)(II).

ticipants expected to elect lump sums. Without this modification, plans can be underfunded when, as now, lump sums are greater than the value of the annuity using the current liability discount rate.

It appears that, at the very least, Congress believed that interest rates inherent in annuity purchase prices and lump sums would be within the range specified by the new law for determining current liability (a 10 percent corridor on either side of a four-year average of 30-year Treasury rates). In fact, we note that the highest permissible discount rate by law has consistently been quite close to corporate bond rates, and above annuity discount rates. In fact, when the highest permissible discount rate fell below the corporate bond rate, Congress fixed it temporarily by putting it back up with corporate bond rates.

Alternatives: An Academy paper in 2002 provided three alternative discount rates for fixing this problem,[4] and they are set forth on the accompanying graph. They are:

- The pension plan's expected long-term rate of return (orange line);
- A high-quality long-term corporate bond rate of return (blue line); and
- Discount rates used in pricing annuities (green line).

The Academy's Pension Practice Council suggests that a corporate bond, an annuity-pricing rate, or something between the two may be appropriate for discounting liabilities for underfunded plans. Although these rates are only about 70 basis points apart, we do not take a position on exactly which index is the "correct" one, since Congress is the appropriate body to decide how to balance the competing interests of benefit security and the employers' ability to maintain the plan. A lower discount rate will improve benefit security (and help the PBGC), while a higher discount rate will help employers' ability to maintain the plan. The next four sections discuss these rates and the long-term Treasury rate (red line).

Expected Long-Term Rate of Return (Orange Line): The Employee Retirement Income Security Act (ERISA) has allowed the enrolled actuary since 1974 to choose a reasonable interest rate (taking into account reasonable expectations) for pension funding calculations. As you can see from the first chart, actuaries have chosen a long-term rate averaging around 8 percent for at least the last 15 years.

In the 1980s, the PBGC noted that the funding rules, taken as a whole, were still allowing pension plans to be underfunded. The biggest problem was in the amortization periods, not in the interest rates for minimum funding. (In the 1980s, the average interest rates used by actuaries were significantly below Treasury rates.) The rules allowed pension plans to improve benefits frequently and pay for them over 30 years (even though the associated benefit increase could be paid out before 30 years). Thus, benefit improvements could defund underfunded pension plans (and provide deferred compensation, possibly at PBGC's expense). Consequently, OBRA'87 changed the rules not only to shorten the funding periods for underfunded plans, but also to require a separate discount rate for the calculation based on the 30-year Treasury rate. The rules specified that pension liabilities for this calculation (known as current liabilities or CL) be determined using a discount rate no larger than 110 percent of the 30-year Treasury rate, averaged over the prior four years (the brown line in the chart). As you can see, it was close to corporate bond rates and, in fact, was actually *higher* than the average interest rates used by actuaries at the time. You can also see that Treasury rates, annuity pricing rates, corporate bond rates, and the maximum allowable rate were closer back then.

Treasury Rates (Red Line): Why was the 30-year Treasury rate chosen? Among other reasons, the Treasury rate was easy to obtain, had a duration similar to pension plans, and wasn't easily subject to manipulation (or, at least, that was the perception at that time). In addition, the rate could be rationalized by employers for funding purposes because the law allowed use of 110 percent of the Treasury rate (which allowed a rate near corporate bond rates), and it was smoothed (by using a four-year average of the rate) so it would not cause excessively volatile contributions and was predictable in advance.

[4] Please read "Alternatives to the 30-Year Treasury Rate" at www.actuary.org/pdf/pension/rate_17july02.pdf for more details.

Today, the Treasury rate is used for determining pension funding amounts, PBGC variable premiums, lump sum amounts, and many other pension items.[5] Unfortunately, Treasury rates have fallen much more than corporate bond rates and annuity rates.[6] For example, from 1983 through 1997, Treasury rates were around 100 basis points below Moody's composite corporate bond rate (except for 1986), but by the year 2000 they were 200 basis points lower. In addition, we now know that Treasuries can be manipulated by the private sector and by the government. A major investment banking firm manipulated prices in August of 1991 and the Treasury showed it could manipulate prices in November of 2001, when it said it would stop issuing 30-year Treasuries. By comparison, a composite corporate bond rate would be much more difficult to manipulate. Corporations would be unlikely to manipulate it upwards to reduce pension costs, because that would increase borrowing costs. In fact, if corporate bond rates ever were manipulated up, annuity prices would presumably be decreased in the same way as bond prices, so the resulting liabilities would still be appropriate.

As noted above, using the Treasury rate increases today's contributions. If today's low Treasury rates are used to determine liabilities,[7] current costs could increase by up to 50 percent over those using long-term expectations.[8] In effect requiring a Treasury rate says, this is what the contribution should be if the pension plan is invested solely in Treasury bonds.[9] The next section discusses the cost assuming the pension plan is invested solely in corporate bonds.

Long-Term High-Quality Corporate Bond Rates (Blue Line): Pension liabilities for financial statements are generally discounted using current long-term high-quality corporate bond rates due to the requirements in Financial Accounting Standard 87 (FAS87) paragraph 44.

In response to statements by the Securities and Exchange Commission, some corporations use a discount rate that is quite close to a high-quality long-term corporate bond index.[10] In fact, the highest permissible discount rate for funding has also been quite close to this corporate bond index (see chart of discount rates). When the permitted rate fell, Congress fixed it by putting it back up

[5] See a complete list on page 13 of our paper entitled "Alternatives to the 30-year Treasury Rate" at http://www.actuary.org/pdf/pension/rate_17july02.pdf. We recommend that the discount rate be changed for every calculation of current liability (both the RPA94 version and the OBRA87 version) so that there is only one current liability number. There is no reason to have two versions.

[6] Why did Treasury rates fall so much compared to corporate bond rates? In August 1998, the CBO's Economic and Budget Outlook suggested that, for the first time in 30 years, the U.S. unified budget would show a surplus; and, in fact, that the surplus would pay off the U.S. debt by 2006 and then build up assets for the government. The government would need to buy back its outstanding Treasury bonds, even if they were non-callable. The law of supply and demand suggests that with reduced supply (and continued demand), prices will go up. Treasury bond prices did go up and their interest rates dropped. In fact, they dropped faster than corporate bond rates, and that has continued since then. (This may also be due to the market's perception of increased risk for corporate debt, particularly at certain firms). This has continued, even as budget surpluses have turned to deficits, probably due to increased demand caused by investors turning from stocks and corporate bonds to the safety of Treasury bonds, and because of decreased supply in the wake of the government's decision in 2001 to stop issuing 30-year bonds.

[7] Even though pension contributions for underfunded plans are determined using 105 percent of Treasury rates (except for 2002 and 2003), lump sums are determined using 100 percent of Treasury rates, which also affects the cost of the plan.

[8] Comparing liabilities using long-term expected costs as a baseline is not intended to imply endorsement of that particular rate. It was merely used because many employers designed their pension plans using those returns. For purposes of these calculations, we assume that the plan is invested 60 percent in equities and 40 percent in bonds, and would yield approximately 200 basis points over corporate bond rates, and that the plan's duration is a typical duration of 12 (i.e., decreasing the interest rate by 1 percent would increase liabilities by 1.01 raised to the twelfth power or 12 percent). The 50 percent comes from (1 + 8.1 percent − 4.7 percent)^12 − 1 = 50 percent. Plans with mostly retirees could have a duration of about 8 (i.e., a 1 percent decrease in the interest rate would increase liabilities by about 8%), while a plan with mostly young employees could have a duration of about 25 (for an increase of about 25 percent for each 1 percent decrease in the discount rate).

[9] Of course, pension plans are not invested solely in Treasury bonds. They are also invested in equities and corporate bonds, with the expectation that they will earn a larger return over the long term. (Ibbotson data from the past 76 years shows that over any 20-year period, stocks have performed better than bonds.) Of course, that is not a guarantee, so employers have taken on a risk that the future may not be like the past.

[10] As noted later, some bond indices do not include items such as call risk, etc.

near the corporate bond rates.[11] Thus, using this rate (or something close to it) would be in accord with the original intent of the rule, and could be considered not to increase the discount rate and lower contributions. If this corporate bond index is used, liabilities are estimated to be around 27 percent higher than if expected returns are used.[12] Except in the case of bankruptcy, a terminating plan that is funded to this amount generally does not provide a risk to the PBGC because, if additional amounts are needed, they are small, and employers have often made the additional contributions to avoid distress terminations (which can be very complex and entail benefit cuts to employees).

Some corporations use (for their financial statements) a discount rate based on a bond portfolio that would match plan benefits with the cash flows from bond coupons and maturity values of this bond portfolio. This means that an employer could hedge its interest rate risk if it held the appropriate bonds (i.e., if interest rates changed, the liabilities could still be matched by the bond cash flows). The investment yield from this bond portfolio would most likely be between the high-quality corporate bond index and the interest rate used by insurance companies to price annuities (which has been approximated by the index minus 70 basis points, as discussed in the next section).[13] Using this rate could improve benefit security further for participants and means the pension plan should be less likely to need trusteeship by the PBGC. If this plan qualified for a distress termination, the PBGC would generally not experience an economic loss (even if PBGC holds those bonds) because PBGC does not guarantee the full benefit, and it does not buy annuities. The PBGC, like employers, self-insures (i.e., does not buy annuities) in order to reap higher returns and avoid the larger expenses, risk margins, and profit loadings of the insurance company.

Discount Rates Used in Pricing Group Annuities (Green Line): The discount rates used in pricing annuities are similar to the corporate bond rates, because when someone buys an annuity, the insurance company invests the money in corporate bonds (often with lower credit ratings of A and Baa, in order to reap the credit risk premium), private placements, and mortgages. A study for the Society of Actuaries by Victor Modugno suggested that these discount rates could be approximated by Bloomberg's A3 option-adjusted corporate bond index minus 70 basis points (for the insurance company expenses, risk margins, and profits). The adjustment is less than 70 basis points if one uses the high quality composite rate suggested by the ERISA Industry Committee (ERIC). Liabilities determined using an annuity discount rate could be approximately one-third higher than those determined using expected returns (or about 7 percent higher than those determined using a high-quality corporate index), assuming the appropriate mortality table is used.[14] A terminating plan with assets equal to this liability amount would be able to buy annuities for everyone, and thus would be less likely to require the help of the PBGC.

Dynamic Process for Setting Discount Assumption: Determining annuity prices is not an easy or exact science, and no one index will work forever without adjustment. Discount rates (and mortality assumptions) vary among insurance companies, and over time companies change their pricing methods, so it is difficult to fix a formula in law that is appropriate for all time. Our 2002 paper and a recent

[11] Graphs of these interest rates show that using a four-year average of this index would be quite close to the OBRA87 interest rates, and the two-year average (or 95 percent of the four-year average or 100 percent of the index minus 40 basis points) would be quite close to the RPA94 and JCWAA rates.

[12] This assumes that expected returns would be around 2 percent greater than corporate bond returns. The 27 percent comes from 1.02^12 − 1 = 27 percent. See footnote 8 for further details.

[13] This rate would be less than the corporate bond rate because it is reduced for default risk (the risk that the debtor will default), call risk (the risk that the bond will be paid off early—generally the last 3 years), and possibly for expenses. (As discussed later, the rate can also be lower if the yield curve is steep and the benefits are front-weighted, due to having a high proportion of retirees, or it can be larger if the duration is long, due to having mostly younger employees.) This rate would be larger than the annuity rate because it would not be reduced for other charges that insurance companies charge, such as profit loadings, risk margins, and commissions. It could be close to the corporate bond index if defaults are very few, the yield curve is flat or inverted or the duration of benefit liabilities is greater than the duration of the long-term bond index, or benefits are large (so that expenses are small as a percent of liabilities), or interest rates are not lower than coupon rates when the call provision is in effect, or lump sums are less than the current liability if/when smoothed interest rates are lower than the current interest rate. On the other hand, the rate could be closer to the annuity rates, for the opposite reasons.

[14] The 7 percent comes from (1 + 60bp)^12 − 1 = 7 percent.

GAO report[15] both suggest that if Congress desires such a rate, it should allow a dynamic process to set it. For example, if Congress carefully defines the rate in law to be the discount rate used in pricing the average annuity, a committee with annuity pricing actuaries, pension actuaries, investment professionals, and government actuaries could set the discount rate. Alternatively, our paper also suggested that Congress could define the discount carefully in law and allow the plan's enrolled actuary to determine it. Either of these methods could also be used to set a high-quality long-term corporate bond rate.

Smoothing: As in our paper, we suggest policy-makers investigate reducing the four-year smoothing rule for discount rates in IRC Section 412(b)(5)(B)(ii)(I) to something less; for example, two-year smoothing (with greater weighting to more recent rates). Otherwise, if interest rates go back up quickly (as they did in the late 1970s and early 1980s), then plans would have to use a discount rate lower than Treasury rates to determine their contributions (i.e., employers would have to increase their contributions even though the plans would have enough funds to buy annuities to cover all plan liabilities.) The Academy's Pension Practice Council believes this suggestion would produce funding requirements that would be reasonably predictable in advance and have enough smoothing to satisfy sponsor concerns. However, if this issue would slow down passage of legislation, it should be deferred for further study. For example, it could take time for regulations to be proposed and finalized, and employers need to know now what the discount rate will be for 2004.

Yield Curves and Hedging: Some actuaries suggest using a current yield curve (i.e., using different rates for different periods in the future, not just one average long-term rate) so that volatility can be hedged by investing in certain asset classes. On the other hand, many other actuaries are concerned about the volatility that could ensue if a plan sponsor did not want to change its investment philosophy and move away from stocks. Thus, they prefer using a smoothed average rate. Therefore, our paper suggested that Congress not mandate a yield curve for funding,[16] but rather allow for it. The IRC could accommodate both if plan sponsors could elect to use the then-current corporate bond yield curve. The use of a yield curve (which could have 30 or more rates) will take time to propose in regulations and finalize, and will add complexity to an already very complex set of minimum funding rules (without necessarily changing the results appreciably, especially when the yield curve is flat). Clearly, it would be too complex for lump sum calculations,[17] and Congress might want to exempt small plans from the calculations or create simplified alternatives, such as one rate for actives and one rate for retirees.

Changing the Discount Rate and Mortality Table at the Same Time. It is widely understood that minimum funding calculations will soon be required to reflect an updated mortality table, which would further increase the required funding for pension plans. It makes sense to make any change in interest rates effective at the same time the mortality table is changed for funding, so that calculation methods only need to be revised once. In addition, because the change in the discount rate and the mortality table affect the liability calculations in the opposite direction, they will have offsetting effects on each other.[18]

Retroactivity: Permitting a change in interest rates retroactively to 2001 could reduce the contributions for some employers immediately by retroactively reducing the contributions that would have been required in 2001 and allowing the reduction in the mandated contribution to increase the credit balance. This increase in the credit balance could then be used to reduce the current-year minimum contribution, which could reduce the current severity of cash flow problems affecting employment, com-

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[15] The GAO (General Accounting Office) report, "Process Needed to Monitor the Mandated Interest Rate for Pension Calculations."

[16] A yield curve has the advantage of pricing liabilities more like the financial markets would (lower discount rates for short duration liabilities). When the yield curve is steep, it would increase the liabilities of hourly plans with large retiree populations by around 5 percent. However, we note that it may not increase liabilities as much as expected since interest rates have less effect on plans with shorter durations. In addition, a more precise calculation might also use a blue-collar mortality table for the hourly plan, which could decrease costs by 2 to 3 percent, and would fully offset the effects of using the yield curve, except when it is unusually steep (e.g., 1992, 1993, 2002, and 2003).

[17] See the reasons suggested on page 12 of our paper on alternatives located at http://www.actuary.org/pdf/pension/rate_17july02.pdf

[18] Changing from the 83GAM to the most recent mortality table, RP2000, has the same effect as lowering the discount rate by up to 0.5 percent for males, 0 percent for females (because their mortality rates haven't improved much since 1983), and 0.25 percent for unisex rates (if 50/50). Thus, changing the mortality table also justifies increasing the discount rate.

pensation, and other benefit issues (and it would increase government tax revenues). However, the retroactivity provision should be optional, so that employers do not have to incur the cost of revising past actuarial valuations or have to change their budgeting of contributions—or lose the deduction for contributions made in good faith on the basis then in effect.

Pension Calculations Affected: As in our paper, we encourage Congress to change the interest rate for every calculation of current liability. Replacing the reference to the 30-year Treasury rate in all of the RPA94 and OBRA87 calculations listed on page 13 of our "Alternatives" paper would increase consistency and simplicity. The use of multiple interest rates and multiple liability numbers is confusing to actuaries, employers, participants, and other interested parties in the general public, such as investors.

Changing the current liability interest rate would not affect certain other calculations, which policy-makers may wish to also consider, including:

- Lump sums under IRC section 417(e), maximum lump sums under section 415, and automatic lump sums under $5,000 under section 411(a)(11), which all use the 30-year Treasury rate.
- The projection of employee contributions under IRC section 411(c), which uses 120 percent of the federal mid-term applicable rate and the 30-year Treasury rate.

Lump Sums: There are reasons for using one corporate bond rate or annuity price (not a complex yield curve) in every place where the 30-year Treasury rate is currently used. For example:

- Simplicity—Only one rate is used, instead of the multitude of rates now used.
- Spousal benefits—The use of Treasury rates for determining lump sums makes the lump sum option more valuable than the qualified joint and survivor annuity. This conflicts with the original intent of ERISA—to encourage pensions to surviving spouses.
- Public policy—The current rules mandating the Treasury rate make it impossible for plans to provide an actuarially equivalent lump sum. Thus, the economic decision to take a lump sum is not a neutral one. Workers can take the lump sum and buy a larger annuity with it (which they rarely do). Thus, the rules encourage workers to take lump sums, which may be viewed negatively from a public policy perspective because more retirees will spend down their lump sum too quickly and end up falling on government assistance (Supplemental Security Income and Medicaid).
- Plan funding—The payment of a lump sum in an underfunded plan decreases the funding ratio, particularly if the lump sum is subsidized by the unusually low Treasury rate. In addition, plans will tend to be less well funded, because Notice 90–11 prohibits the subsidy from being included in the current liability calculation. This is not only a concern for participants,[19] but also for the PBGC.
- Increased costs beyond amounts intended—Plan sponsors have to contribute more funds to the plan because the low Treasury rate made lump sums larger (not because the employer decided to increase lump sums). Thus, the plan is more expensive than the employer originally intended.
- Obstruction of bargaining process—Due to the expense of paying larger lump sums, plan sponsors are less likely to make plan improvements suggested by workers at the next bargaining period. Thus, requiring the Treasury rate ignores the collective bargaining process and discriminates against participants that don't take lump sums. If employees were permitted to decide where the funds should go, staff in labor organizations have told us that bargainers would probably use the funds to improve the benefit formula for all workers, instead of just for those workers who take lump sums.

Changing to a higher interest rate can reduce a worker's lump sum, so a transition rule may be helpful. For example, ERIC and ABC suggest phasing in the interest rate change over three years. Their phase-in could limit the increase in the interest rate to about 0.5 percent per year.[20] We note that Treasury rates have increased in the past, so this would not be the first time that lump sum interest rates have increased. The Treasury rate went up in the 1990's by more than 1 percent

[19] For example, retirees of Polaroid are suing their former employer for paying the mandated, subsidized lump sums to recent retirees, because they are defunding the plan. This means the retirees will have their benefits cut down to the guaranteed benefit by PBGC.

[20] Unless all interest rates go up dramatically in the next three years.

three times (i.e., 1994, 1996, and 1999). Furthermore, with this transition, a worker's lump sum may not go down. It may still grow because each year a worker gets additional service and pay increases, and their age gets closer to the normal retirement age (NRA).[21 22]

In addition, we suggest Congress simplify the very complex calculations caused by § 415(b)(2)(E) for maximum lump sums. One simple alternative suggested by ASPA (the American Society of Pension Actuaries) would be to use just one interest rate. Our paper, "Alternatives to the 30-Year Treasury Rate," suggested that it could be somewhere in the 5 percent to 8 percent range. The Academy has also suggested to the Treasury Department in the past that the rules could be greatly simplified by deleting the words "or the rate specified in the plan" in Section 415(b)(2)(E), so that the maximum lump sum would be the same in all plans (and the discount rate used above and below the Normal Retirement Age would be the same).

PBGC's Financial Status: Another issue that policy-makers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount rate in accordance with earlier intentions (which is close to a corporate bond rate or annuity-pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans for a few more years (hopefully, until the economy recovers). This could mean that fewer plans will need to be trusteed by the PBGC and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer retirement programs. However, that statement comes with a caveat. Since increasing the interest rate reduces minimum contributions, there may be a need to review the funding and premium rules in the near future, particularly if PBGC has more major losses over the next couple of years in this current economic downturn.

Due to the triple whammy of plummeting stock prices, lower interest rates, and more bankruptcies, the PBGC has gone from a surplus of $10 billion just two years ago to a $3.6 billion deficit. However, the dollar amount of the deficit may not be as relevant as the funding ratio, which is 90 percent. Each time the PBGC takes over a pension plan, it also takes over the plan assets. PBGC's assets are now over $31.5 billion[23] while its annual outgo is expected be around $3 billion. Thus, the PBGC will not have problems fulfilling its primary mission for a number of years— to pay guaranteed benefits on time. This is not to say that we do not need a change in the funding rules. On the contrary, the Academy has already met with the PBGC to discuss ways to fix them. We are just saying that PBGC's large asset base allows time to thoroughly discuss how to fix the funding rules before enacting them.

This discussion so far has only taken into account PBGC's past terminations. However, PBGC's financial status is also intimately linked with how industries (like the airline industry) fare over the next several years. The pension underfunding at several weak airlines exceeds $10 billion. In fact, PBGC's 2002 Annual Report forecasts that future claims could be twice the average of past claims—a clear signal it may want to double premiums and/or tighten funding rules.

Risk-Related PBGC Premiums and Funding Rules: Recently, the PBGC floated the idea of charging higher premiums (or strengthening the funding rules) for plans that present more risk to them (e.g., plans with high levels of equities and plans sponsored by weak companies). These rules might be helpful to strong employers so that they would not have to subsidize weak employers. However, employer groups[24] say their members have not asked for these fixes, possibly because almost all plans have over 50 percent of their assets in equities. And many employers are wary of

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[21] Each year, participants get one year closer to their normal retirement date (NRD), which means their lump sum increases by one year's interest rate (unless they are already beyond their NRD, in which case the lump sum can decrease).

[22] Another idea might be to freeze the lump sum dollar amount on the amendment date (using the accrued benefit on that date), so that the lump sum amount would not decrease unless the old rules would have reduced it (e.g., due to the Treasury rate going up or due to the participant being beyond the NRA, or due to a case where a large early retirement subsidy is in the lump sum). However, this would require two lump sum calculations and thus could be a little more complex to calculate than the 3-year phase-in idea.

[23] This $31.5 billion amount includes the $6 billion in assets from probable plans in PBGC's FY 2002 annual report (such as Bethlehem Steel), because PBGC includes such liabilities in the report.

[24] For example, the Committee on Investment of Employee Benefit Assets (CIEBA), the ERISA Industry Committee (ERIC), and the American Benefits Council (ABC).

basing these calculations on credit ratings because they could someday have lower credit ratings themselves[25]—and because this approach may result in significant cost increases for companies that can least afford them. In addition, implementing these risk-related premiums and funding rules would raise many complex issues (in an area that is already overly complex). For example, credit ratings might be needed for non-rated private employers, subsidiaries of foreign owners, and individual controlled group members. Risk levels would be needed for stocks and bonds (and some bonds present more volatility and/or mismatch risk than certain stocks). Plan sponsors might seek ways to temporarily avoid the riskier investments on the measurement date, and if those rules were tightened it could hurt the markets when pension plans started selling equities. However, if PBGC needs to substantially increase its premiums because of large increases in claims, some strong employers might be willing to discuss risk related premium and funding ideas. Maybe there are ways to help make them more palatable such as:

- transition rules;
- delayed implementation;
- exemptions for current benefit levels, while assessing for benefit increases; or
- caps on the increase in the premium or the 0.9% multiplier (similar to the $34 per participant cap that was placed on the initial variable premium legislation).

Other Reforms: There are many other ideas that could be considered, such as:

- To make it more difficult for weak companies and underfunded plans to increase benefits.[26]
- To address the cost of shutdown benefits (or not to guarantee them).
- To get contributions into the plans earlier. The PBGC tells us that pension plans frequently do not contribute in their last year when the PBGC takes over the plan. Thus, requiring sponsors of underfunded plans to make contributions by year end (or very soon thereafter) could help the PBGC. Employers might be amenable to this rule if quarterlies were eliminated. This could also enable quicker reporting of pension plan financial information, which would also be valuable to the PBGC and the markets, and be a positive step in the direction of greater clarity and transparency.
- To suspend the use of the credit balance when plans are very underfunded. (PBGC notes that some companies don't have to pay their deficit reduction contributions because they have a large credit balance.) Another way to reduce that concern in the future would be to reduce the 30-year amortization period for plan amendments.
- To improve PBGC's standing in bankruptcy courts, and give presumption to PBGC assumptions for determining their claim in bankruptcy.
- To increase disclosure.

In addition, we have been asked what reforms would be helpful for hourly and bargained plans[27] because they are more likely to be underfunded than salaried plans. Reasons for this are:

- They are amended frequently to update benefit levels for inflation. These amendments can be funded over 30 years (even though the increased retiree benefits can be paid out much faster). If plans are very underfunded, they have to amortize benefit increases over 3 to 7 years by means of the deficit reduction contribution. One compromise might be to smooth out these rules so that there is not such a large cliff between them. Congress might consider

[25] In addition, reflecting credit rating changes would make contributions and premiums more volatile.

[26] For example, charge a larger premium rate (on just the benefit increase) that is risk related, require faster funding (fund benefit increases faster than 30 years; FAS already requires employers to expense benefit increases over a much shorter period, and the deficit reduction contribution rules already do that when the funding ratio is under 80 percent or 90 percent continually), or prohibit the benefit increases unless liens are provided as in Section 401(a)(29)—and just increase the 60 percent threshold to 70 percent or 80 percent.

[27] Some of these ideas might apply to both single and multi-employer plans, so the suggestions may also be applicable to both. In fact, having different rules for these hourly plans can set up arbitrage opportunities that some plan sponsors have tried to exploit. (Multi-employer plans need not pay variable premiums or deficit reduction contributions.) Some of the reasons for the difference in the rules may be that the multiemployer guarantees are smaller than those for single employer plans, the PBGC multiemployer fund has a surplus, and it is more difficult for multi-employer plans to change their contributions in the middle of a bargaining period.

reducing the 30-year period (FAS already requires companies to expense benefit increases over a much shorter period).

- When assets exceed current liability, the plan sponsor can't make a deductible contribution. If funding rules allowed hourly plans to deduct contributions even if assets exceeded current liability, then hourly plans could advance-fund their future benefit increases.
- They are more likely to be in industries that have large legacy costs payable to large retiree populations (in comparison to smaller workforces). Shorter amortization periods and allowing margins would help this too.
- They can experience large asset losses, and may find it difficult to amortize them over a small workforce, even if assets cover their retiree liability. Immunization of the retiree liability in underfunded plans could be discussed, but Congress would need to be careful about removing the flexibility plan sponsors currently have to invest pension assets in the way that best fits their plan and the ever-changing economic conditions.

These are all very complex ideas and have far-reaching implications for the pension world, so they should not be implemented until after major discussion and analysis.

Allowing Contributions in Good Years: We recommend that employers be allowed to make a deductible contribution to their pension plans in years when they are healthy and can afford it, even if assets are above 100 percent of current liability. Currently, contributions in this situation may not be deductible and may also be subject to an excise tax. When interest rates were higher, the full funding limit allowed a pension plan to have a margin above current liability (see second chart). That margin is also needed when interest rates are low, particularly for plans that are retiree-heavy and for hourly plans, which cannot easily advance fund their benefit increases. Congress could allow a contribution up to (for example) 130 percent of current liability minus assets. Alternatively, the definition of the full funding limit could have (for example) 130 percent of current liability as a minimum. At the very least, the excise tax on nondeductible contributions could be eliminated in this situation.

We also note that there are strong incentives for companies to contribute more, and companies have learned a lot lately about the risks inherent in pension plan funding. Recent drops in the market have provided a good reason for employers to increase their funding margins and build a cushion to protect against adverse experience. Thus, companies may be more willing to contribute more than necessary in the future to avoid falling below certain key thresholds, if the law allows them a deduction (or at least doesn't penalize them with an excise tax for making nondeductible contributions). For example, if assets fall below the accumulated benefit obligation, accounting rules may force a major hit to the company's net worth. If assets fall below the liability for vested benefits, companies must pay an additional premium to the PBGC. If assets fall below 90 percent of current liability, contributions can increase dramatically.

A list of the penalties follows. If policymakers want to increase the incentives for funding, then the threshold for one or more of the penalties could be increased (e.g., the threshold for security).

If the funding ratio falls below	Then
125%	No § 420 transfer to the company post-retirement health plan Company cannot use the prior year valuation
110%	Restrictions on the size of lump sums to the top 25

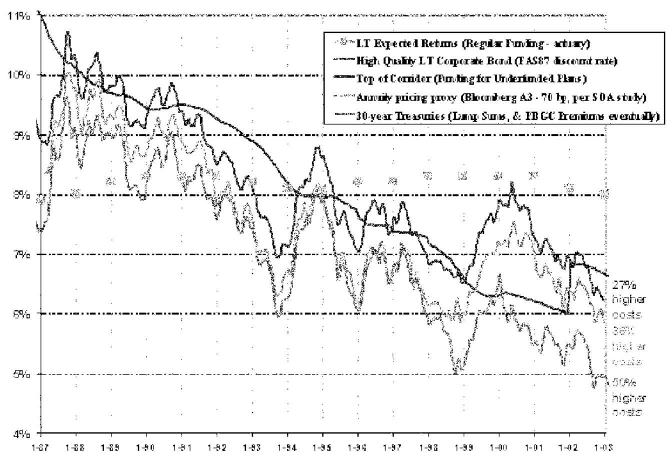
If the funding ratio falls below	Then
100%	Accounting rules may force a hit to net worth if unfunded ABO > $0 PBGC variable premiums are payable Companies must pay quarterly contributions PBGC files lien on company if missed contributions > $1 M PBGC financial filings required if underfunded over $ 50 M Must report certain corporate transactions to PBGC if underfunded Bankrupt firms cannot increase benefits
90%	Additional deficit reduction contributions required Notice to employees with funding ratio and PBGC guarantees required
60%	Security required for plan amendments

We believe many employers will contribute enough to reach a key threshold margin in order to avoid these problems.

Being forced to fund when the plan sponsor cannot afford it and being precluded from funding when the plan sponsor can afford it is unreasonable, self-defeating, and difficult for the PBGC. We hope Congress will consider making this fix, which does not cause problems (because it is voluntary), except for reducing tax revenues. However, we don't believe that the revenue loss will be as large as might be expected because it may not be used heavily in the near future and, to the extent that it is used, it will reduce contributions in the future. In addition, it could reduce PBGC claim amounts and the number of underfunded terminations.

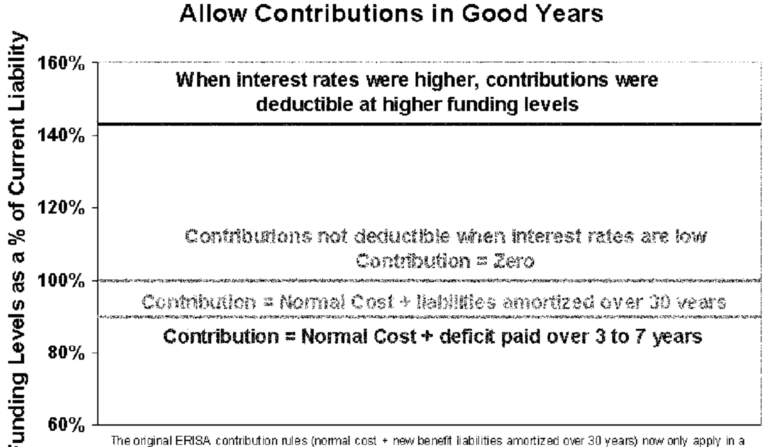
We at the American Academy of Actuaries hope that a permanent alternative to the 30-year Treasury rate can be enacted quickly. In addition, we are also very interested in working with Congress and the PBGC to consider funding ideas further. Thank you for holding this hearing and inviting us to speak before you today.

Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. They produce the costs indicated (relative to LT Expected Returns used for funding), assuming an average pension plan (with duration around 12). The expected returns are from Watson Wyatt surveys.

Allow Contributions in Good Years



The original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). At one time they applied to all plans. The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

Chairman MCCRERY. Thank you, Mr. Gebhardtsbauer. Let me begin with you. Changing the current 30-year Treasury rate has been controversial as it relates to lump sum payments, lump sum distributions from plans. Why should the Congress apply a new interest rate to the calculation of lump sum payments?

Mr. GEBHARDTSBAUER. The Academy actually doesn't take a position on what it should be, just that the current rate that is being used, the Treasury rate, is very low, and what it does is it creates a lump sum which is sometimes larger than what it would cost to buy an annuity. So, for instance, you could take the lump sum out of the pension plan, go across the street and buy a larger annuity, but a lot of people don't buy the annuity. They take the lump sum, and they spend it and might spend it too quickly. In addition, if they had taken the annuity, they would have the annuity for the rest of their life. So, I think good public policy is to encourage annuities and not encourage lump sums.

In addition, if they take an annuity, they had the chance to provide an annuity not only for themselves for the rest of their life, no matter how long they live, but also for their survivor; again, another public policy issue. In addition, if they run out of money, they may fall upon SSI and Medicaid. So, it becomes an issue for the government in the future. Having these interest rates so low, the government is in fact encouraging employees to take lump sums.

In addition, from the employer side, the more people take lump sums, especially in an underfunded pension plan, they get a hundred percent of their money when they take the lump sum out. If you have an underfunded plan that makes the plan worse funded. It defunds the pension plan and so it leaves the people who are remaining with less, and so the employers end up having to put more money into the pension plan than they originally intended.

These lump sums at one time were at a much higher interest rate back when the employer set up the pension plan. This determined how much the pension plan was going to cost. Now the lump sums are so much more, the pension plan will cost more.

Chairman MCCRERY. Explain succinctly why current law, the 30-year Treasury rate encourages a pensioner to take the lump sum rather than the annuity.

Mr. GEBHARDTSBAUER. If I was to give advice to a pensioner, I would have to tell them that if they came up to me and said, "Which is more valuable, this annuity or this lump sum?" I would have to tell them the lump sum is more valuable. So, the advice they would get from an experienced practitioner like myself would encourage them to take the annuity and they may then not take the annuity.

Chairman MCCRERY. Why is it more valuable?

Mr. GEBHARDTSBAUER. For instance, they can go across the street and buy an annuity. In fact, at John Hancock, one of the actuaries there told me, it is common knowledge, everybody there knows the price of annuities. So, they do take lump sums. They don't even have to go across the street. They go across the hall and buy a bigger annuity than what the pension plan would have provided.

Chairman MCCRERY. So, in other words, they can take the lump sum distribution and purchase in the private marketplace an annuity which will pay them monthly benefits in excess of the monthly benefits they would receive from their company's pension.

Mr. GEBHARDTSBAUER. That is right. It defunds the pension plan because they are taking out more money from the pension plan than was needed to pay for that pension.

Chairman MCCRERY. Also the company is paying more in effect than they had guaranteed the employee under their pension plan.

Mr. GEBHARDTSBAUER. That is correct.

Chairman MCCRERY. Okay. The Department of Treasury has proposed an extension of—a 2-year extension of the relief we provided in last year's tax bill with no changes. If we extend last year's tax relief, would it provide the same amount of relief as it did last year?

Mr. GEBHARDTSBAUER. This is probably a good question for Ken, but there is a concern if you extend the temporary provision that it still leaves a lot of uncertainty and eventually will have to address this issue with more hearings and what are we going to do in 2 years from now. So, creating a definite result, a permanent result, is much preferred.

So, there is the uncertainty problem, like when Ken said he has to make projections for the analysts, what are our contributions going to be. We don't know what it is going to be. As far as what the result is going to be you can see it on the chart over here. Using 120 percent of the Treasury rate, because it is a 4-year average right now it is above Treasury rates, but it's gradually coming down because Treasury rates over the last 4 years have been coming down, so the rate next year would be lower than the rate this year.

Chairman MCCRERY. So, it would not provide the same amount of relief.

Mr. GEBHARDTSBAUER. It would be better than going back to the 105 percent of the Treasury rate; yes, 120 percent would be better but it would not be quite as good as the interest rate today.

Chairman MCCRERY. Would you recommend any changes to the temporary fix?

Mr. GEBHARDTSBAUER. The Academy actually hasn't thought about it. We just found out today that people at the Department of Treasury are considering continuing the temporary fix for another 2 or 3 years or something like that. So, we actually have not gotten together to think about whether it is appropriate or not, because we have been thinking about what should be a permanent rate; and we think a permanent rate should be a function of corporate bond rates, because that is what insurance companies use to price their annuities, and that is also what you can immunize your benefit payments with by buying corporate bonds. As you all know, Treasury rates are much lower now compared to corporate bond rates than they were in the past when Congress originally chose to use Treasury rates.

Chairman MCCRERY. I have some more questions but I am going to yield to Mr. McNulty and the rest of the Committee, then I will get back to my other questions. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman.

Professor Stein, following on to that previous conversation, for the purposes of lump sum distributions you advocate a more conservative interest rate than that used for plan funding and other statutory purposes. It would seem that this approach provides a built-in incentive or incentives to elect the lump sum benefit over an annuity. Shouldn't pension policy strive for neutrality between the two?

Mr. STEIN. You have to think about this from the participants perspective. If you are looking at equivalency from the participants' perspective, the participants generally are not going to have access to the same rates of return that an insurance company that provides an annuity would or the same kind of return that a plan can get—so when a participant is thinking about equivalencies they are thinking about what kind of return can I reasonably get, and that is going to be a lower rate of return than the kind of corporate bond discount rates that we have been talking about today.

So, from the participant's viewpoint I am not certain that the point is really accurate that this necessarily would favor annuities. I can also tell you what Ron said is right; people do look at relative values of annuities. When I call Ron—and I have called Ron in the past—Ron always asks what kind of rate of return does the participant think they can get, which is a very important fact.

We also don't believe that most participants are primarily motivated by the size of the annuity in deciding whether to take a lump sum or not. In a lot of cases, the employee is leaving the employer and just doesn't want the employer to have control of the retirement wealth, wants to get that money out of the employer's hands. Indeed, I have seen many situations where participants are considering a choice of a lump sum or a subsidized early retirement benefit. Very often in plans the lump sum does not include the subsidized value of the Federal retirement benefit. Even in such situations, however, participants often initially lean toward the lump sum, even though it is far less valuable. So, I don't think relative value is the primary motivator in many cases.

I think the kind of situation Ron was talking about, the employees of John Hancock who are probably getting fairly substantial lump sums, I think they are very sensitive to the extra value in the lump sum and they can probably approximate the same kind of returns that the plan hopes to get. I think when you are thinking about, for example, somebody who has mandatorily cashed out with $5,000 or less, they are not going to be able to achieve that same rate of return. In addition, if you want them to preserve those benefits by rolling them over, it is much more likely if the benefit is larger that at least part of it is going to go into an IRA and be there for retirement.

Mr. MCNULTY. I thank the professor and I thank the other witnesses as well, and this is all I have for right now, Mr. Chairman.

Chairman MCCRERY. Mr. Ryan.

Mr. RYAN. No questions.

Chairman MCCRERY. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Gebhardtsbauer, did I get that right?

Mr. GEBHARDTSBAUER. You did a great job, better than I did for my first 8 years.

Mr. COLLINS. I liked Ron. It was a lot shorter.

Mr. GEBHARDTSBAUER. You can call me Ron.

Mr. COLLINS. Thank you. Two questions. You mentioned a while ago that we had procedures that forced companies to make contributions when—that were not having such a good year, and we prohibited them from making contributions when they were having good years. I saw for a minute, and then again I may be right; you have not got this mixed up with alternative minimum tax, have you?

Mr. GEBHARDTSBAUER. In fact, this particular slide up here talks about that. When interest rates——

Mr. COLLINS. You didn't understand the question. You have not gotten your testimony mixed up with the alternative minimum tax, have you? That is kind of the way it basically works, too. Tell me about that. Tell me why in years of good profits, and of course there are bad years, that we limit and require——

Mr. GEBHARDTSBAUER. I think employees have learned a lot about risk lately. When you have a well-funded plan, there are a lot of things you can do that you can't do now. When you have a well-funded plan, you can move money into the health plan. If you have over 110 percent of your liabilities covered with assets, you can pay lump sums to all the employees, including the top employees. Under 110 percent, you are restricted what you can pay in lump sums. Under 110 percent you have to pay PBGC's premiums; under 90 percent you have to contribute more.

Mr. COLLINS. What limits the contribution in good years?

Mr. GEBHARDTSBAUER. This chart shows about how at one time when interest rates were much higher, when the rules were made, employers could put money in, even though they had their liabilities covered with assets. The rules don't work as well when interest rates are low like right now. When interest rates are low, hourly plans can only put up to 100 percent of their liabilities. It can't create a margin.

The rules say that the full funding limit is the greater of two numbers, and I apologize if I get too detailed here, but one is based on projecting—it is a projected number, but it uses long-term average interest rates. Whereas the number that is in effect right now, that is normally bigger, is what they called the unfunded current liability number, and that is based on the Treasury rate right now; and it says that you can't put any more in this, and the reason for that is because the government wants to make sure that employers can't just put in anything they want in good years.

Mr. COLLINS. Are there tax provisions that limit the contributions in the good years, is that the basic bottom line?

Mr. GEBHARDTSBAUER. Yes.

Mr. COLLINS. That is where I was. That is what I was asking.

Mr. GEBHARDTSBAUER. That is right. What the rules do now, at 100 percent you can't put anything in. Then if you fall below 90 percent, then you don't have what is called the comfort zone, you have to immediately put in the deficit reduction contribution. You are treated as if you are a very poorly funded plan and you have to put a lot more than you ever thought you would have to put in. So, a lot of companies went from zero in the nineties, now they are hit by this heavy-duty contribution.

Mr. COLLINS. What are the tax provisions that limit in good years.

Mr. GEBHARDTSBAUER. In section 404 there is one rule that talks about the full funding limit—I think 404(a).

Mr. PORTER. I don't remember the exact reference but there is an excise tax. If you are at the full funding limit and you want to put a contribution in your plan, the Tax Code imposes an excise tax, nondeductible, for having made that contribution. So, in our plan's case, since we were a full funding limit from 1985 till 2002, if we had made a $100 million contribution in 1985, we would have had cumulative excise taxes on that one contribution of $170 million to $180 million, and we still would not be able to take the tax deduction. So, while it was permissible to put a contribution in, the board of directors probably would have let me go, because it's a dumb financial decision. I think the rule back then was a result of a little bit of a tug-of-war between funding policy, where you want to make sure the plans are funded well enough, and revenue, which says if we let companies put too much in, it is going to impact the Federal revenues because it is a tax-deductible contribution. So, there is a cap on what can be contributed, and it is enforced by an excise tax.

Mr. COLLINS. Does this contribute to the airline industry problem?

Mr. GEBHARDTSBAUER. I don't know enough about the airline industry to know.

Mr. COLLINS. They are underfunded, aren't they?

Mr. STEIN. Certainly plausible. There is another aspect to this, too. When the full funding limit was created was the era when employers were terminating plans to capture surplus assets, and the legislative history of that provision suggested that one reason that we are putting this full funding limitation in is because the plan might be terminated and the employer might withdraw the money for non-pension purposes. To a very large extent that has been corrected now, because you have the excise tax when the employer takes a reversion from a terminated plan, and thus there is no longer the incentive that Congress might have envisioned for gaming. I think most people think that the only reason to keep something like the full funding limitation in is as a revenue raiser, and it may not be a very good reason. It has really created problems, although Congress has addressed many of them recently.

Mr. COLLINS. If we don't keep them fully funded and they go belly up, then who takes care of it?

Mr. STEIN. Well, two people take care of it: The PBGC and the participants, if their benefits exceed the PBGC guarantees.

Mr. COLLINS. Same folks.Thank you, Mr. Chairman. I knew the Tax Code was at the bottom of this pit, causing this problem, sucking the wind out of it. Just couldn't get Mr. Gebhardtsbauer to come to that point.

Mr. GEBHARDTSBAUER. Norman mentioned another provision and that was the excise tax, as Congress may have gone too far there on the excise tax. They put in a 50 percent excise tax. If you end up putting more money in the plan, you want to encourage companies to put more money in the plan. If they do now and then 20 years down the road if the stock markets have done well, they maybe have way too much money in the pension plan, they can't get it out, and if they do take it out they have to terminate the plan in order to take it out; and in order to do that, they end up giving 50 percent of that in certain situations, plus 35 percent income tax, plus State income tax, so it can be up to like 90 percent of their reversion. If you think $100 million of that surplus is yours, it's actually $90 million goes to government and you get $5 or $10 million, so that is discouraging employers to put more money in.

Chairman MCCRERY. Mr. Pomeroy.

Mr. POMEROY. Mr. Chairman, I want to begin by thanking you for holding this hearing. I think this is a very important issue. The questions have been excellent and the witnesses have been excellent as well. We really need to force I think some activity here, and I think this hearing has done a good bit of that.

Mr. Gebhardtsbauer, you ought to have a little medal because you have got the longest darn name I have seen in the Committee on Ways and Means.

Mr. GEBHARDTSBAUER. Thank you for inviting me back, still.

Mr. POMEROY. Do you know, or the actuaries know by virtue of your clientele about activity relative to freezing plans?

Mr. GEBHARDTSBAUER. With freezing, I have just heard a lot of actuaries talk about how a lot of them are either freezing, or a lot of them are talking to their actuaries about freezing and what is the consequence or what would we have to do in order to freeze. So, that is a concern, I know, for a lot of actuaries talking to their clients. In addition, in your prior question I believe you were asking PBGC if there might be a way for them to determine something on that, because when people file premiums, they tell PBGC how many employees are still in the pension plan. So, if it is not going up anymore, that might be an indication; or if it is going down, that would be an indication that the plan is being frozen.

Mr. POMEROY. That is true. I don't want to burden employers with significant additional paperwork but it would seem like a notification of plan frozen would be—would produce data that would be useful in evaluating where our pension universe is, but would not be very hard on the employers. Correct—would that be useful data?

Mr. GEBHARDTSBAUER. I guess they are already reporting something like that, because when you amend the pension plan you have to provide the Department of Labor and the participants information. I don't know if that is still being provided to the Department of Labor, but it could just be provided quicker now.

Mr. STEIN. The 204(h) requires whenever you reduce benefit accruals that you notify the Department of Labor.

Mr. POMEROY. If this Committee wanted to find activity relative to plans being frozen, we could look to the Department of Labor and they would have a universe of data they could pull for us.

Mr. STEIN. I think we would all be hesitant to say "yes," they will definitely have that data, but I think we would all be willing to say they "probably will have it."

Mr. POMEROY. I will ask and we will tell you, we will find out. I think we need to find out that information.

Mr. STEIN. There are other pressures, other than I think the funding pressures, that might be causing employers to look into freezing plans.

Mr. POMEROY. I actually was—my next question was going to be is the pressure on DB plans today about as severe as anyone has seen, so it is a good segue into what your observation was going to be, Mr. Stein.

Mr. STEIN. I am probably not the—the funding issue comes at a time when we are having a maturing population as well, and in traditional DB plans maturing populations cost employers more money. So, you keep hearing the term "perfect storm." I think it is an overused metaphor, but the low interest rates coinciding with asset values—but you also have the demographics which are costly to employers.

Mr. POMEROY. Employers trying to make their stock more attractive to investors, so they are making these kinds of changes for purposes of capping or limiting the unknown liabilities going forward on their pension plans. I agree with you I think there is very severe pressure on all sides.

Mr. STEIN. It is very hard for the employee who has been in one of these DB plans for 20 or 25 years and all of a sudden finds——

Mr. POMEROY. They lose out on the bargain, Mr. Porter, from your business perspective.

Mr. PORTER. I think if you look at what a corporation goes through in deciding how to spend benefits dollars, there are tensions. One tension is the business leaders in particular product lines want to see their costs variable. They want costs to go up when their employment costs are up; they want their costs to go down when employment times are down. Pensions frequently work counter cyclical to that. They say okay, if I am going to bear the cost of a counter cyclical expense, what am I getting for that, what am I buying in terms of employee relations, what am I buying in terms of quality of life?

The equation here historically has been pension plans can fund more effectively than an individual can invest. It has been a long-term proposition. If I have a dollar to spend in a pension plan versus a dollar to spend in a 401(k) because I as a company can weather the storms up and down, up and down, I can provide a more valuable annuity out of a DB plan than I can out of a DC plan, and the 401(k) is totally the employee's risk. So, historically employers have been willing to spend and accept the volatility of pension funding and expense on the proposition that it is a better deal for their employees, and dollar-for-dollar of benefits delivered is less expensive. What's happened in recent years, with changes in funding laws and changes in pressures and global pressure, is that the benefits of having a DB plan have deteriorated, and we have to focus on what is happening now.

Mr. POMEROY. Benefits for who? The employer or the employee?

Mr. PORTER. Perceived benefit from an employer perspective, what is my tradeoff? If I can get some value in employee relations, value for what I am delivering for my employees at a reasonable cost that would be important to do, but if the cost of providing those benefits now outweighs the benefits perceived to be delivered, then the employers tend to have less of an interest in a DB plan. The 30-year T-bills as they affect funding right now, make it more expensive to fund a pension plan than to fund a 401(k). Ultimately the employees get better value out of a 401(k) for the dollars spent by the employer.

Mr. POMEROY. The employer gets better value?

Mr. PORTER. Dollar for dollar, if I historically look at it and said if I could put a dollar in, let us look at a cost and the benefit delivered down the road, the DB plan was cheaper because I could earn more in it. As you make funding more onerous and put pressures on corporations, therefore, to perhaps reduce the amount of equities in their portfolios, the equation starts to change and it is no longer more cost effective for the employer to fund through a DB plan. For the same amount of ultimate benefits delivered, it may just be as cost effective to fund through a 401(k). So, what I am seeing, not so much in my own company but talking with other companies, the Council, and to my contacts, is companies are making the decision that all the hassle just isn't worth the risk anymore.

Mr. POMEROY. I really believe that is a loser for employees, because I still think it is a better deal. That captures it all as far as I am concerned from employees, and if they don't perceive the value today, they will when they are 80-years-old and broke and they are not getting an annuity every month, sustaining their income in retirement years no matter how long they live. I really think that we are rushing toward an absolute train wreck in terms of how this is all—in terms of income security and retirement, and the demise of the pension that we are presiding over is an important part of that.

Mr. PORTER. When you look back at when ERISA was first enacted, there was a lot of discussion of a three-legged stool: investments, Social Security, and private pensions. What they were really talking about was a two-legged stool: capital accumulation and wealth—and income guarantees. Social Security and DBs tended to be income sources. Personal savings, now 401(k), is capital accumulation. The movement has been away from preservation of income toward development of capital.

If you hear the debate as I am hearing it, toward transparency and accuracy—what we are discussing is a debate between accuracy for pension funding versus smoothing. I think that is the same debate we have had for a lot of years, because smoothing is a bedrock of pension funding. Transparency is a bedrock of capital accumulation. So, as I look at the question of accuracy versus smoothing, I say accuracy is a short-term measure. Smoothing is a long-term measure. Accuracy is something investment markets want. Smoothing is something that we need for a strong DB social policy.

So, it is a fundamental tug-of-war between capital accumulation and income guarantees; and it is a tug-of-war between whether we want to have a social policy in this Nation to preserve income protection for the elderly or if we want to go to a capital accumulation market-based economy.

Mr. POMEROY. I believe what you said was so perfectly expressed and right on point. How ironic that maybe last decade we get jerked over to the asset accumulation side, but to be this decade still not focused more on the income security side, when next decade, in 2010, there will be 78 million Americans that will turn 65 the next decade. We are doing nothing to pre-position ourselves for that, either with public resources or privately.

I used to be an insurance commissioner. I remember the days when there was a lot of insecurity about insurance company solvency and a lot of pressure on insurance regulators that to get a mark to market you have got to have this capitalized, you have got to have capital requirement of mark to market. Not everybody cashed in on the same day. That is a ludicrous artificial measure that didn't in any way reflect the likely liabilities, any scenario of liabilities on life insurance companies, so we pushed back and resisted.

It seems like that dynamic has a lot of application to this question. This is why smoothing, I believe, is a much more appropriate measure over time than some kind of artificial reserving requirement these companies will never have to meet based on the actual draw on their pension funds.

I thank the gentlemen very much. I know Mr. Stein is dying to contribute, but I am out of time unless the Chairman would so provide. It has been an excellent panel. All three of you, thank you very much.

Chairman MCCRERY. Mr. Porter, in your written testimony you noted that the PBGC's funding situation is serious but does not require increases in pension funding or PBGC premiums. If we were to increase premiums, would that increase the likelihood of plans being frozen or terminated and therefore being added to PBGC's liability?

Mr. PORTER. That is a real good question and I think all of this works together dynamically. If we don't fix funding, that increases the liability that companies terminate their pension plan. Every pressure on a company will increase that pressure. The question is which of those evils do you like least or which of the evils can you live with the most? I personally believe a sound, funding policy for our Nation, with appropriate recognition of the long term, is what is going to be best. If we do something Draconian today—and by that I would simply say, well, we just do nothing and let the current temporary fix expire and nothing changes, that would be so dramatic that PBGC would see significant increases in their liabilities.

So, I would analyze the alternatives and say that the latter one is the worst alternative. All of them could have some negative effect. What we need is to find the best balance that will protect the system, not only the PBGC but the retirement system in our Nation. That is my view.

Chairman MCCRERY. Let us talk about a replacement for the 30-year Treasury rate. When the 30-year Treasury rate was selected as the benchmark, it was thought to be transparent and difficult to manipulate and dependable, to be an accurate proxy, forever. Now we know that wasn't true. How can we know that any replacement that we choose will remain an accurate proxy in the future?

Mr. PORTER. I don't know that there are any guarantees in this life. What we know from experience is that anything based on a government rate is subject to the unilateral decision of the Department of Treasury or of the Fed to take action on those bonds, so that those can be changed rather dramatically very quickly.

On the other hand, considering market-based bonds, which are based on corporate rates, there is a large number of corporations issuing bonds, it seems highly unlikely that the actions of one employer or one bond agency would have as dramatic an impact as the actions of one government. So, I don't believe there is a guarantee, but I think it is a much better approach.

Chairman MCCRERY. Should we give the Department of Treasury the latitude to adjust the interest rate to ensure its accuracy?

Mr. PORTER. I am not sure what that latitude would mean, so it is hard to respond.

Chairman MCCRERY. So, you would be content to just tie the interest rate to some corporate bond mix that would float with——

Mr. PORTER. I think with our proposal and what is in H.R. 1776 is that the Department of Treasury has the ability to monitor various corporate bond indices. If one of them somehow is out of line they can get it out of the mix. So, they have some flexibility around that, but they don't have flexibility to say, well, we are going to abandon corporate bonds and go to something else.

Chairman MCCRERY. Okay.

Mr. PORTER. I think that kind of monitoring is probably appropriate.

Chairman MCCRERY. Okay. In his testimony in the first panel, Mr. Kandarian noted that healthy, well-funded plans tend to subsidize the unhealthy, underfunded plans by paying premiums to support those plans when they are terminated and taken over. How does your company feel about paying higher premiums to subsidize the underfunded plans, and should we strengthen the funding rules to reduce or eliminate this cross-subsidizing?

Mr. PORTER. Nobody likes to pay more premiums. As we had been paying premiums for these years with really no reasonable expectation that we would ever need to rely on the PBGC's support, that is all money we have paid for social costs. It is effectively a tax to protect the program, and a fair amount of taxes is probably reasonable.

The real question is how big will it get, and to the extent that corporations that have been responsible plan sponsors will have to pay for those that have been less responsible. Our pension plan was founded in 1904 so we are 1 year shy of 100 years in the plan, started funding it in the early twenties.

Mr. PORTER. We have been a responsible employer funding our plans, and nobody from a company like that likes the idea that they might have to take over somebody's liabilities who perhaps wasn't acting as responsibly. Having said that, something that is fair and balanced should be acceptable—that is what this whole bill is about, is a fair and balanced proposal—has to be considered.

Chairman MCCRERY. Mr. Stein, last question. You argue that a replacement rate should more closely track annuity plan rates and that a corporate bond rate misses the target. Can you tell us by how much you think the corporate bond rate overstates the target and also how much you think the 30-year Treasury rate understates the target?

Mr. STEIN. Yes. Let me start by saying that I talked to a couple of people before the hearing. If Portman-Cardin were adopted, I think the discount rate or the interest rate that we would be using would be in the mid-7 range, 7.5, 7.6. Just as a gut reaction that seems to be very high, higher than it should be.

What the rate should be, it is very difficult. Really, when you are talking about annuity pricing, you are talking about what somebody—how much you have to pay somebody to accept these liabilities in an open market. One of the concerns I have about using a corporate bond rate is, those are bonds that have some level of risk and we are depending on outside agencies whose track record is nowhere near perfect to tell us how much risk each of those companies reflected in a particular index is. The index itself is not entirely transparent. Only some companies are rated, some of the rating agencies charge to be rated.

The advantage of using some Federal rate as a start and then adding basis points to it, rather than taking the corporate rate and subtracting basis points from it is—we always know, I think, what a riskless rate of return means; what it means is stable, does not change from time to time. Five years from now we may be back here because it turns out that the corporate bond rates turn out not to really be what insurers are using to price annuities.

So, I know in speaking with some actuaries they said, well 70 or 80 basis points or 50 basis points less than the corporate bond rate would replicate annuity pricing now. Of course, PBGC does a survey of insurance companies for determining the interest rates it uses. That has some problems, too, but that is another approach that might be taken.

I hesitate to say I agree with the Department of Treasury here. I think there is a real need for a permanent fix now, but I think it is an issue that really requires more thought than has been given.

I do note that when I speak to actuaries in private they often say, I can't say this publicly, but the corporate rate is too high. They all agree the Treasury rate is at least somewhat too low. Some people have suggested the applicable Federal rate, which is used for a lot of purposes in the Internal Revenue Code, might be a starting point. I think there are some problems with that, but that is another possibility. I would actually like to see you get a bunch of people in a room and be able to close the doors and none of their clients will know what they say, and have them come out with sort of a base-closing kind of recommendation. That might be something that could be done quickly.

There are other problems with the funding rules right now that probably need to be addressed in unison with discount rates; for example, the mortality rates that we are using are not accurate for a lot of industries. In many cases they overstate and in some cases understate liabilities. That probably needs to be fixed, too. Portman-Cardin does have something in there that would fix that problem for blue-collar industries, but we are still awaiting accurate mortality tables for white-collar industries.

Chairman MCCRERY. Mr. Gebhardtsbauer.

Mr. GEBHARDTSBAUER. I wanted to mention that if Congress some time ago had decided that they wanted to approximate what the annuity rate was, they could have said Treasury rate plus 50 basis points, but because Treasury rates are much lower now, if you took the Treasury rate and added 50 basis points you wouldn't be close enough. It would be better if Congress had taken the corporate rate, say, and subtracted 50 basis points or half a percent or 70 basis points. It depends on what corporate rate you are using. The reason is, at least right now, insurance companies primarily invest in corporate bonds and mortgages, that kind of investment. They don't invest as much in Treasury bonds. So, it would be a much better approximation.

I also agree with the GAO report that said that it is hard to know exactly what insurance companies are going to be charging in the future. They may change their methods someday in the future. So, they also recommended that if you do set something to an annuity rate, which is kind of hard to estimate, you might want to create a Committee of actuaries and economists inside and outside the government to set it. That is one of the problems with basing it on an annuity rate. In fact, insurance companies don't all agree and use the same rate. There is a range even today among several different insurance companies. So, what is the appropriate rate is a little bit unclear. So, that is why if you were to do a proxy, it would be much better to take the corporate rate and subtract something, rather than Treasury bond and add something.

Chairman MCCRERY. Well, just to be clear in case anybody is wondering why we don't just go to the market and say what is your interest rate that you are paying on annuities, generally insurance companies don't divulge that, do they?

Mr. GEBHARDTSBAUER. There is a survey right now that the PBGC collects on a quarterly basis, where they get the group annuity pricing rates for a handful of large insurance companies, but the information is kept private. We actually don't have the details. Then they produce what they call—actually they don't call it an interest rate, they call it an interest factor, because it is not exactly right. They combine it with a slightly old mortality table to get the interest rate. So, you can't use PBGC's rate. In fact, when I was there at the PBGC as the Chief Actuary, we wanted to improve the way we calculated the PBGC interest rate based on this survey of insurance companies. We asked Congress not to use our interest rate anymore even though we based it on the survey, because we wanted to change it and perfect it, but we didn't want to perfect everybody's lump sum in the whole country. That is when Congress did decide to use the 30-year Treasury rate for lump sums.

Chairman MCCRERY. So, why wouldn't we want to use that survey now instead of corporate bonds, some mix of corporate bonds?

Mr. GEBHARDTSBAUER. I guess some people are concerned about the survey because only the PBGC is involved in it. The PBGC is also concerned about it being used, too, because then they can't do something with it because they wouldn't want to manipulate all the lump sums in the country without Congress being involved in that decision. An alternative would be maybe a Committee, maybe like GAO was talking about, getting this survey and the Committee could include people in the government and people in the private sector and actuaries and economists who could use that survey to come up with what the appropriate pricing for lump sums if you wanted to use an annuity rate.

Chairman MCCRERY. Well, I think what we are looking for is the most accurate measure.

Mr. GEBHARDTSBAUER. The Committee question of what is the most accurate measure, I have to admit I don't know exactly what is—I know the Department of Treasury was talking about the perfect answer. I don't know. I would say something in the range of annuity prices or corporate bonds. Maybe it gets back to something that Norman was talking about, too, if the participant says I want my lump sum. He was saying that they maybe cannot make as good an investment as the insurance company. Actually there are reasons why participants can actually do better. If they are 40, and they take the lump sum from the company, they are not restricted like insurance companies. Insurance companies are restricted to only having bonds generally, they can't have equities. Whereas individuals can have equities. The probability is that they will have more money by the time they retire if they invest in a mixture, a diversified portfolio of bonds and stocks, than they would if they had left it with an insurance company and only earned a bond rate. Now, there is the probability that they may not do as well, but likely over 20 years the stock market has always done better than bonds.

We don't know that the future will be exactly like the past, but the probability is they will actually earn a higher rate of return than an insurance company. So, that is why an active employee getting a lump sum at a younger age—it doesn't necessarily say the perfect answer is the annuity pricing.

Mr. PORTER. Let me add to that. What Ron has described is about what the PBGC will do for their internal purposes. It is change from time to time depending on how they calculate and do their survey. To the extent they do that and because other things are tied to it, there is an impact; just like other things are tied to the 30-year T-bonds and a unilateral action has changed them.

If you take the chart that the Academy of Actuaries has—I keep a copy of that every month in my folder because it is great stuff, he sends it to me every month. If you look at all the various interest rates that are plotted on here, everything seems to work together nicely. It doesn't matter which rate you use, they all seem to follow fairly well, with the exception of the 30-year T-bond. So, if you want something that is less subject to manipulation, you need something that is market based.

Chairman MCCRERY. Okay. Thank you very much. Appreciate your testimony. We look forward to working with you some more to solve this problem. The hearing is adjourned.

[Whereupon, at 5:34 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of AARP

AARP is a nonprofit membership organization of 35 million persons age 50 and over dedicated to addressing the needs and interests of older Americans. Of those 35 million members, approximately 45% are working. Each of the AARP publications—the BULLETIN and AARP: The Magazine—reaches more households than any other publication in the United States.

AARP fosters the economic security of individuals as they age by seeking to increase the availability, security, equity, and adequacy of pension benefits. AARP and its members have a substantial interest in ensuring that participants have access to pension plans that provide adequate retirement income.

AARP would like to express its strong concern about proposals to change plan funding rules that would have a significant negative impact on single-sum retirement benefits for millions of employees in defined benefit pension plans. As your Committee and the Congress consider substitutes for the 30-year Treasury interest rate and related changes to these pension provisions, we urge you to protect and preserve participants' benefits, including annuities and single sums. While it is appropriate to review the use of the 30-year Treasury rate for funding purposes, the law should maintain a more conservative 30-year Treasury rate for determining the value of benefits payable in a single sum.

Overview

The interest rate on 30-year Treasury bonds is a key element of the statutory provisions determining the value of single-sum benefits in defined benefit plans, the employer's ability to cash out pension benefits without the employee's consent, the contributions required of employers sponsoring underfunded plans, and the premiums those employers must pay the Pension Benefit Guaranty Corporation, as well as other provisions. Proposals to move away from the 30-year Treasury bond interest rate have been prompted by two distinct factors: First, 30-year Treasury bond rates have become artificially lower because of the Treasury's decision to stop issuing the 30-year bond. Second, generally low interest rates (including the 30-year Treasury rate) combined with a weak stock market are currently imposing added funding pressures on employers that sponsor defined benefit plans.

However, American workers too are feeling the pressure of falling rates and a weak market. These developments have dramatically lowered both the account balances and the expected returns that working families have been counting on for a more secure retirement. Congress should not compound this hardship by changing the law to reduce guaranteed benefit amounts. At a minimum, Congress should retain an interest rate for determining single-sum benefit amounts that is consistent with the historical level of the 30-year Treasury rate. This can be done by maintaining the traditional relationship or spread between the current statutory single-sum rate and any higher market rate that may be selected for funding purposes.

In addition, to the extent that legislation prescribes any new single-sum interest rate benchmark, even one that attempts to replicate the traditional spread for the 30-year Treasury rate (after adjusting for the effect of Treasury debt reduction, buybacks and discontinuance of the 30-year Treasury bond), fundamental fairness to employees dictates that any such change be phased in very gradually.[1]

Funding Rates and Single-Sum Rates Have Been and Should Continue to Be Different

Some have argued that the interest rates used to determine plan funding and the rates used to determine the amount of single sum distributions should be identical. But those rates are not the same today, have not been the same for years, and should continue to differ if Congress amends the relevant provisions. Under current law, the rate used to determine the present value (the single-sum equivalent) of a pension annuity benefit is the 30-year Treasury interest rate. By contrast, the rate used to determine contributions to underfunded plans for 2002 and 2003 can be as high as 120% of a four-year weighted average of 30-year Treasury interest rates.

Not only have the single-sum rate (the 30-year Treasury rate) and the maximum permissible funding rate been different, but the relationship between them has not remained constant from year to year. The spread between the two rates has varied as the four-year weighted average has changed and as Congress reduced the highest permitted funding rate for underfunded plans from 110% of the four-year weighted average (established in the Omnibus Budget Reconciliation Act of 1987) to 105% over a five-year period before increasing it temporarily to 120% of that average.

It is appropriate that the rates for these different purposes be different, and that the single-sum rate be a more conservative rate. Employees and employers have different needs and different capacities to bear risk. In particular, an employer is in a different position in relation to the risk that interest rate volatility will increase plan liabilities than an employee is in when confronting the risk that interest rate volatility will reduce her single-sum benefit below its anticipated level. Employers often can compensate for uncertainties in the market by funding more in advance and, if the plan's funded status deteriorates, by contributing more to make up for that after the fact.

By contrast, employees nearing retirement—who are counting on a single sum of

[1] Thus, for the reasons set out in this statement, AARP opposes conforming the single-sum rate to the funding rate, and giving participants only transition relief with respect to the resulting benefit reductions, as some have proposed. See, for example, section 705 of H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, introduced on April 11, 2003 by Reps. Portman and Cardin.

By contrast, employees nearing retirement—who are counting on a single sum of a specific value based on disclosures received from the plan—need greater protection from the risk that a rise in rates will reduce the benefit they have reasonably been expecting. Older employees in particular may not have sufficient time to adjust to a benefit reduction. And as plans provide employees more and improved disclosure of expected single-sum and other benefit values, employees will tend to place increasing reliance on the expected level of their benefits.

In recent times, we are seeing all too graphically the effects of market risk on individual employees' retirement benefits in defined contribution plans (particularly where employees are not diversified because their accounts are over-concentrated in employer stock) and in individual retirement accounts. For employees, defined benefit pension plans can provide a refuge from market risk and other investment risk. But if the benefits in defined benefit plans—which millions of employees have been earning over many years—are reduced during the low points in the business cycle, when markets and plan asset values are down, that would undermine the risk protective function of these plans—one of the principal virtues of the defined benefit system.

There is no good time to cut pension benefits; but the worst time to do so is when employees have suffered major declines in their 401(k) and IRA balances and when the interest rates and other returns they can expect from investing pension distributions are so low. Low interest rates for determining single-sum distributions are not out of line with the low interest rates available to individuals on their investments outside of qualified plans.

The Historical Relationship Between the Rate for Determining Single-Sum Benefits and the Highest Rate Permitted for Funding Underfunded Plans Can and Should Be Preserved

The American Academy of Actuaries has indicated that 30-year Treasury bond rates were roughly 100 basis points (or 1%) lower than long-term corporate bond rates from 1983 through 1998 (while the funding rate—the highest interest rate allowed for funding underfunded plans—was close to the corporate bond rates).[2] The Academy's 2002 paper on this issue stated that Treasury rates have been about 200 basis points lower since the beginning of 2000,[3] although the past few months have seen this spread return closer to the more historical difference of 100 basis points. The Academy's paper attributed only a portion of the increase in the spread to federal debt reduction and buy-backs, attributing the remainder of the increase to the recent flight to safe investments such as Treasury bonds.[4]

The spread between the rate used to determine single-sum benefits and maximum rate required to be used for funding should be preserved, after adjusting appropriately for the effects of Treasury debt reduction and buybacks and Treasury's decision to discontinue issuance of the 30-year Treasury bond. Under this approach, assuming the law is changed to replace the 30-year Treasury rate for pension funding with a standard that is based on a different rate or rates, the rate used to determine single-sum benefits (including present values for purposes of involuntary cash-outs) would be set at a specified number of basis points below the funding rate(s). In addition, transition relief should be provided to employees to buffer the effect of any increase in the single-sum rate that is associated with an adjustment to reflect the Treasury buybacks and the discontinued status of the 30-year Treasury bond.[5]

As a related matter, because of employees' vulnerability to risk, Congress should consider whether they need greater protection from single-sum interest rate volatility than current law provides. This might be accomplished through the use of a trailing average of interest rates or by other means.

Lower Single-Sum Rates Are Consistent With Good Pension Policy

Some argue that single-sum interest rates should be increased significantly to reduce the value of single sums and discourage employees from electing them. The theory is that single-sum payments are undesirable as a matter of policy, and that reducing the value of single sums would promote retirement security by discour-

[2] During most of this period, the highest permissible funding rate for underfunded plans would have been 110% of the four-year trailing average of the 30-year Treasury rate. Thus, for example, at a time when the 30-year Treasury rate was 10%, the funding rate would have been 11% (assuming the four-year trailing average did not differ from the current rate).

[3] Parks, J. and R. Gebhardtsbauer, American Academy of Actuaries, Alternatives to the 30-Year Treasury Rate (A Public Statement by the Pension Practice Council of the American Academy of Actuaries), July 17, 2002, pages 4–5 and Charts I and II (comparing 30-year Treasuries to Moody's composite long-term corporate index).

[4] Id. at 5.

[5] Id. at 5.

aging employees from choosing them. But national pension policy should enhance retirement security by minimizing "leakage," or cash-outs, of benefits from the pension system, rather than reducing the value of employees' single-sum benefits. In fact, by preserving larger single sums, individuals will ultimately realize greater retirement security.

The notion that reducing the single sum calculation will indirectly discourage such payments—and that fewer single sums mean greater preservation of benefits—glosses over a number of important realities in the pension system.

First, in many cases, employees have no choice between a single-sum payment and annuity or other benefits. Involuntary cash-outs of benefits that do not exceed $5,000 in present value represent a very substantial percentage of all single-sum distributions. These payments are chosen not by employees, but by employers.

Paying involuntary single sums allows plan sponsors to reduce costs by no longer paying PBGC premiums for the cashed-out employees and by saving the administrative cost of maintaining the benefits and related records. When an employee receives a single-sum payment, whether voluntarily or otherwise, the cost of maintaining those assets shifts to the employee (such as the cost of investing and administering the assets in an IRA or taxable account). Indeed, this shift of cost to the individual is yet another reason the more conservative Treasury bond rate is the appropriate benchmark.

Increasing the single-sum interest rate would also shift the benefits of more employees below the $5,000 threshold, thereby subjecting more employees to involuntary cash-out. It is these small single-sum distributions that are most often consumed instead of rolled over to another plan or IRA.

Second, when employees do have a choice between an annuity and a single-sum benefit, it is not at all evident that their choices are determined by incremental differences in the actuarial value of the annuity compared to that of the single sum. Employees' choices seem to be more sensitive to a variety of other factors that create a highly uneven "playing field" between annuities and single-sum options.[6] These other factors—which might favor or disfavor the single sum—include

- the tendency of many employees to prefer large, immediate cash payments (without regard to any mathematical comparison of the actuarial values of the single-sum and annuity options);
- the inclination of some employees to prefer a single sum because of the belief that funds invested outside the plan would earn larger returns than any growth that might occur if some or all of the benefits remained in the plan (again without regard to actuarial comparisons);
- the current environment, where an annuity guaranteed for life may be more preferable because it will always tend to be more secure than a single-sum payment, which might diminish in value if the employee invested it outside the plan (again without performing or studying actuarial comparisons);
- the fact that some plans heavily subsidize early retirement annuities but not single-sum options, so that the early retirement annuity has a significantly greater actuarial value than the single sum;
- the expectation of an employee who is in ill health that his or her life expectancy will be brief and that a single sum payment is therefore preferable almost without regard to the comparative actuarial analysis; or
- the wide differences in the availability of single-sum options among defined benefit plans sponsored by various employers—some offering no single sums (with the possible exception of involuntary cash-outs), others offering single sums only at retirement age, and others offering single sums upon termination of employment at any age[7]; and
- the strong tendency of hybrid plan designs, which portray the single sum as the presumptive form of benefit, to move people to a single-sum payment. In fact, cash balance plans and other hybrid plan designs may well be the most dramatic factor currently promoting a shift from annuities to single sums.[8]

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[6] By contrast, employers' choices are more sensitive to such differences because their funding and other calculations are aggregate in nature, often covering thousands of employees over many years.

[7] Defined benefit plan sponsors that offer single-sum distributions generally are not required to do so, just as they are not required to make single-sum cash-outs of small benefits; they choose to do so.

[8] In fact, plan sponsors' interest in offering single-sum distributions—whether responding to or stimulating employee interest in single sums, or some of both—has been one of the motives

In practice, factors such as these generally overwhelm the effect a particular level of interest rate will have on the likelihood that a given individual will opt for a single sum as opposed to an annuity. Employees choosing between single sums and annuities do not generally think or behave like actuaries. This is further evidenced by the fact that participants in traditional defined benefit plans often choose unsubsidized single sums over subsidized early retirement annuities, even when the latter are actuarially far more valuable. Such plan designs are not uncommon, and are yet another reason why interest rates for single-sum purposes can reasonably be lower than the rates that apply for plan funding purposes.

Reduced Single-Sum Amounts May Encourage Defined Benefit Plans to Offer Single-Sum Options

Lower interest rates for determining single-sum options, which result in larger single-sum amounts, may discourage at least some plan sponsors from offering single-sum options. Conversely, legislation increasing the level of the interest rate benchmark for computing single sums would likely have the effect of increasing the number of defined benefit plans offering single sums (and the number of plans offering single sums at termination of employment instead of only at early retirement age) by making single sums less costly for the plan. (This is in addition to generating more nonconsensual single-sum payments by pushing more employees below the involuntary cash-out threshold, as discussed above.) As a result, such a change not only would reduce the value of single-sum benefits across the board, but could result in even greater leakage from the defined benefit system.

Single-Sum Payments Should Not Always be Avoided

It is not even clear as a general proposition that single-sum payments are to be avoided because they necessarily promote more leakage of benefits. Many pension distributions are made when employees leave their jobs before reaching retirement age. At such a point in an employee's life, a single-sum payment might be the best choice from a policy standpoint, provided it was rolled over to another employer plan or IRA. By contrast, an immediate annuity could begin the consumption of retirement savings before retirement age; and leaving the benefit in the former employer's traditional defined benefit plan might well cause the value of the benefit to erode with inflation.

While a single sum is the form of payment that is most at risk to be consumed before retirement, it is also the form that may best serve the preservation of retirement savings through the rollover of such funds. Again, it is not the single sum that should be avoided, but the premature consumption of those funds prior to retirement. In fact, larger single sums, if preserved, will ultimately lead to greater retirement security.

Preserving the Value of Single-Sum Benefits Need Not Cause Underfunding

Some have urged an increase in the interest rate for single-sum benefits (to an amount equal to the annuity rate) on the ground that plans that pay single sums will otherwise become underfunded or "defunded." However, the principal problem here appears to be constraints imposed by the IRS on the ability of underfunded defined benefit plans to fund for projected single sums as opposed to annuities.[9] One possible solution would be to change the IRS position to clearly allow plans to be funded taking into account the size and frequency of anticipated single-sum payments.

Congress Has Other Means to Promote Preservation

Congress has more positive and more effective means of promoting preservation of benefits than reducing benefits paid in single-sum form. The law can encourage

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for the widespread conversion of traditional defined benefit pension plans to cash balance pension plans. Many cash balance plans present the single sum to employees as the presumptive form of benefit, and are adopted with the purpose of reducing the volatility that can affect single-sum benefits in traditional defined benefit plans. Moreover, cash balance plans, far more often than traditional defined benefit plans, typically offer single sums at termination of employment as opposed to only at retirement age. Accordingly, cash balance participants ordinarily decline the annuity (which the plan is required to offer) in favor of the single sum.

[9] The Pension Practice Council of the American Academy of Actuaries has stated that "[I]f participants can elect single sums (generally determined using a 30-year Treasury rate or a possibly-lower plan rate), then plans should be allowed to use that single sum interest rate in determining liabilities." Parks, J. and R. Gebhardtsbauer, American Academy of Actuaries, Alternatives to the 30-Year Treasury Rate (A Public Statement by the Pension Practice Council of the American Academy of Actuaries), July 17, 2002, page 8, n15. The actuaries suggest revising IRS Notice 90–11 "to allow the actuary to determine a plan's liabilities reflecting expected single sum amounts for that percentage of participants who are expected to elect lump sums . . ."

rollovers and plan-to-plan transfers, while discouraging pre-retirement withdrawals that are not rolled over or transferred. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) not only has liberalized the availability of tax-deferred rollovers but provides for automatic rollover of involuntary cash-outs to IRAs unless distributees explicitly direct a different disposition. (The automatic rollover provision, section 657 of EGTRRA, will not be effective until after the Labor Department issues administrative guidance.) Such changes, strongly supported by AARP, are the types of changes that will promote preservation without reducing benefits.

Interest Rate Policy Should Address Needs of Both Employers and Employees

Plan sponsors have valid concerns about their funding obligations, particularly following Treasury's decision to stop issuing the 30-year Treasury bond. At the same time, employees have a valid interest in the preservation of their benefits, including those in the form of a single sum. This point was made repeatedly and forcefully to Congress by constituents receiving single-sum payments in the mid-1990s after enactment of the Retirement Protection Act (part of the GATT legislation), which reduced single-sum payments by raising the statutory interest rate. Aggrieved pension participants blamed Congress and the Executive Branch for not only the portion of the reduction in single sums that was attributable to the legislative change, but also the portion of the reduction that was attributable to a rise in interest rates that occurred shortly after the legislation was enacted. We can expect a similar reaction from participants in the future if they find that Congress again has reduced their single-sum benefits.

Conclusion

Congress must recognize both the important plan funding concerns of employers and the needs of the employees our pension system is designed to serve. The conservative 30-year Treasury rate is an appropriate single-sum benchmark that recognizes the shift of risk and cost to the individual who receives a single-sum payment, and a rate consistent with the 30-year Treasury rate should be maintained. Should Congress deem it appropriate to provide funding relief to plan sponsors, that relief should not come at the expense of individuals' guaranteed benefit amounts. It is particularly important to protect employees from reductions in their pension benefits at a time when they are already struggling with significant declines in their personal and retirement savings accounts. Congress should therefore continue to prescribe different interest rates for these different purposes to address the legitimate needs of both employers and employees.

Statement of Donald W. Fisher, Ph.D., American Medical Group Association, Alexandria, Virginia

On behalf of the American Medical Group Association, I am submitting this statement for the Committee on Ways and Means Subcommittee on Select Revenue Measures' hearing record of April 30, 2003. The American Medical Group Association (AMGA) represents medical group practices, including some of the nation's largest, most prestigious integrated health care delivery systems. AMGA medical group practice members deliver health care to more than 50 million patients in 40 states; the average AMGA member group has 272 physicians and 13 satellite locations.

AMGA endorses the approach of the Pension Preservation and Savings Expansion Act of 2003 (HR 1776) introduced by Representatives Portman and Cardin, and urges the Subcommittee Members to support this bill. This thoughtful approach represents a constructive contribution to the dialogue and directs the discussion in a positive direction.

Many AMGA members, large integrated group practices, own and operate healthcare facilities and employ large numbers of employees, providing them many benefits, including defined-benefit pension plans for employees and retirees. The specter of using of the 30-year Treasury Bond rate to value pension fund liabilities—and the resulting misleading and inaccurate designation of underfunded pension plans—threatens the financial security of employers, employees, and retirees.

Use of the 30-year Treasury Bond rate, a low and discontinued valuation rate, to calculate future pension fund liabilities inaccurately and artificially enlarges pension fund liabilities of all employers—some by almost 20%. As a result, the short-term funding levels are mischaracterized as inadequately low, requiring significantly inflated employer contributions and variable premium payments.

Large integrated medical group practices face extraordinary pension contributions that, if continued, will require diversion of resources needed for medical service delivery to maintain fund payment levels. If not remedied, the options confronting AMGA members, like other large companies, are to freeze their defined pension plans or discontinue this important benefit to workers and retirees.

Not-for-profit medical groups need these funds to fulfill their community commitment to patient care and medical service for the needy. Although our member medical group practices are still analyzing the impact, they are already reporting that it would be disastrous, diverting hundreds of thousands of dollars that are needed to maintain provision of healthcare services. Initial reports from some smaller members indicate increased contributions in the $200,000–$300,000 range; large members anticipate payments of almost half a million.

While the impact is considerable for other large employers as well, consider the detrimental local and national impact this could have on healthcare services provided by large medical group practices of national and international renown.

We applaud Representatives Portman and Cardin for their Pension Preservation and Savings Expansion Act of 2003 (HR 1776) that proposes a permanent, consistent pension calculation rate through use of stable, long-term indices as the basis of the rate benchmark.

AMGA urges the Subcommittee Members to consider this legislation that corrects the present valuation method for determining pension liabilities by implementing a predictable, accurate evaluation of necessary contributions.

Thank you.

Statement of Connecticut Hospital Association, Wallingford, Connecticut

Founded in 1919, the Connecticut Hospital Association (CHA) has been representing hospitals and health-related member organizations for over 80 years. CHA's diverse membership includes all 31 Connecticut acute-care hospitals and their related healthcare organizations, short-term specialty hospitals, long-term care facilities, nursing homes, hospices, home health agencies, ambulatory care centers, clinics, physician group practices and many other organizations. CHA provides legislative and regulatory advocacy on behalf of our members by supporting initiatives that are in the interests of our members and their patients. Like other employers, Connecticut hospital and healthcare employers have been hard hit by spiraling pension plan costs. Declining asset returns and dropping interest rates have collided, resulting in unprecedented, unreasonable and unmanageable financial strains for hospitals and other employers.

CHA is submitting this testimony to be part of the record of the April 30, 2003 hearing on the challenges facing pension plan funding. Connecticut hospitals need pension funding liability reform, and we urgently request your support of legislation to permanently replace the 30-year Treasury bond as the interest rate used to calculate defined benefit pension plan liabilities and lump sum payments.

The temporary funding relief enacted by Congress in 2002 through the Job Creation and Worker Assistance Act (P.L. 107–147) expires at the end of 2003. When that happens, the permissible interest rates that must be used to calculate a plan's current liability and variable rate PBGC premiums will revert to lower rates based on 30-year Treasuries. As Chairman McCrery noted in his opening remarks, Congress chose a four-year weighted average of the 30-year Treasury rate as a benchmark interest rate assumption in calculating whether pension plans meet various funding requirements because the 30-year Treasury bond rate was deemed to be transparent, difficult to manipulate, and a fair proxy for the price an insurer would charge for a group annuity that would cover accrued benefits if the plan were terminated. However, in 2001 the Treasury Department discontinued issuing 30-year bonds and the interest rate on the outstanding bonds has fallen significantly. Chairman McCrery quoted a recent report by the General Accounting Office that states the rate has "diverged from other long-term interest rates, an indication that it also may have diverged from group annuity rates."

When the temporary funding relief expires at the end of this year, reverting to the artificially low Treasury bill interest rates will force hospitals and other employers to unnecessarily increase the funding of their defined benefit plans, diverting desperately needed resources from their services and businesses. In the case of hospitals, which are facing escalating pharmaceutical and technology costs, an expensive and growing workforce shortage, reductions in Medicare and Medicaid reimbursement rates, and spiraling medical liability insurance premiums, this additional financial burden can result in onerous plan design changes.

If the temporary funding relief measure expires without a reasonable replacement to the 30-year Treasury bill interest rate, Connecticut hospitals will face financial hits that they simply cannot absorb. Here are some examples of what has happened to Connecticut hospital pension funding requirements:

In the case of one community hospital with an operating budget of about $70 million, the hospital would have an additional funding requirement of $2–3 million next year, solely due to the change in interest rate.

In the case of a small community hospital, required pension funding jumped from $2.8 million to $4.8 million in one year.

Another mid-sized hospital reports their pension contribution will be up between $1–2 million.

A large, urban hospital reports that between 1999 and 2002, its pension plan's current liability funded percentage has declined by 20 percentage points, 12 percentage points of which are attributable to declining rates according to their actuaries.

Another small community hospital reports a nearly 10-fold increase in their cash funding, from $258,000 in 2003 to $2.3 million in 2004, despite asset returns that were better than the major benchmarks.

At a meeting of hospital leaders earlier this month, the impact of dramatically increased pension funding costs was discussed. Several hospitals are evaluating plan revisions to cut benefits as the only solution to an untenable financial strain.

We urge your support of a solution to address this issue of unnecessary increased funding resulting from the use of the obsolete 30-year Treasury bond rate. Without a swift and permanent solution, such as the reform proposal introduced as part of the Pension Preservation and Savings Expansion Act of 2003 (H.R. 1776), hospitals and other employers will continue to be burdened with artificially inflated plan liabilities that compete for precious resources and will continue to need to question their ability to commit to defined benefit programs for their staffs. Action is needed immediately in order to avoid difficult decisions by employers regarding cost containment actions needed for the new plan year.

Statement of the ERISA Industry Committee

Mr. Chairman and members of the Subcommittee, The ERISA Industry Committee appreciates the opportunity to present its views on the funding of 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.

ERIC has a unique interest in funding rules for defined benefit plans because about 95% of the ERIC membership sponsor defined benefit pension plans. They also provide 401(k), health, and other benefits.

Summary

In 2001 the U.S. Treasury ceased to issue the 30-year Treasury bond on which the funding of defined benefit plans is statutorily based. As a result, we are left with an artificial interest rate that fails to reflect any rational basis with which to regulate pension plan funding. The lack of a rational rule has created uncertainty that, among other effects, has caused the stock of sound companies to be undervalued by stock analysts concerned about their potential future funding obligations.

Prompt action to replace the defunct 30-year Treasury bond rate for purposes of regulating pension plans is critical to protect the retirement security of millions of American workers and to avoid undercutting the ability of many companies to fuel national economic recovery.

ERIC urges the Committee to replace the 30-year Treasury rate with a composite rate of high-quality, long-term corporate bond indices that would be selected through Treasury regulations. ERIC also proposes to

- Coordinate the new rate with related mortality assumptions;
- Phase in the new rate for lump sum calculations; and
- Reduce the frequency with which employers bounce in and out of the current liability funding and quarterly contribution requirements.

A composite corporate bond rate is generally recognized as a reasonable proxy for annuity purchase rates, which corresponds to the rationale for choosing 30-year Treasury rates as a benchmark in 1987. The proposed composite rate is higher than today's 30-year Treasury rate. But this is appropriate because the current use of the Treasury rate *overstates* the minimum funding needed to assure retirement security for plan participants.

The overstatement of liabilities frequently is requiring the diversion of hundreds of millions of dollars in a single company. Overstating liabilities is forcing some employers to make economically rational decisions to freeze, modify, or abandon their defined benefit plans, thus adversely impacting retirement security. Use of the defunct 30-year Treasury rate also causes participants to elect lump sums in circumstances where they would be better protected by an annuity.

Other possible replacements for the 30-year Treasury rate do not provide the combination of simplicity, transparency, relevance, immunity from manipulation, and availability provided by a composite corporate bond rate.

Congress must be careful not to overreact to reports raising concerns about the current status of pension funding. Part of the problem is that current law mismeasures the severity of any problems. In addition, the combined impact of a dramatic drop in asset values combined with an increase in calculated liabilities due to low interest rates is unusual and is not a sound platform for major reshaping of pension funding requirements.

At the same time, Congress should recognize its ability and responsibility to improve the climate for defined benefit plans in the future. For example, Congress imposed ever-harsher deduction limits on voluntary contributions to pension plans during the 1980s and 1990s, a trend that the Grassley-Baucus pension reform measures enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107–16) began to reverse. Had restrictive deduction limits not been imposed during recent decades, many plans would be better funded today despite the current economic slowdown.

Finally, the current financial status of the Pension Benefit Guaranty Corporation (PBGC) should be monitored by Congress, but does not require any action at this time. The PBGC's funded ratio still is stronger than it has been for most of its history, and the corporation is abundantly able to pay promised benefits to participants in plans it trustees for the foreseeable future.

Overview of Funding Rules

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, ERISA and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan. These minimum required contributions are calculated using reasonable assumptions and are equal to the normal cost of the plan plus amounts necessary to amortize over specified periods unfunded past service liabilities, experience gains or losses, waived funding deficiencies, changes in actuarial assumptions, and certain other items. Most defined benefit plans are funded under these original ERISA rules, as modified over time.

A plan that is either significantly or persistently underfunded will be subject to an additional set of funding rules. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan, accelerating the pace of pension funding. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994, and are the focus of our discussion today.

The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is within a range of rates based upon the four-year weighted average of 30-year Treasury bonds. As amended in 1994, amendments, the permissible range is no lower than 90% of the 30-year bond average and no higher than 105% of the 30-year bond average. For 2002 and 2003 only, a plan may use a rate of up to 120% of the 30-year bond average. Congress enacted this short term-higher range last March (P.L. 107–147) in recognition of the fact that, as a result of the rise of budget surpluses followed by the decision of the Treasury to cease issuing 30-year bonds, the 30-year bond rate had dropped to levels that produced highly inaccurate and inflated calculations of pension liability.

The current liability rules come into play if, using these mandated assumptions, a plan is significantly or persistently underfunded—that is, if plan assets are less than 80% of current liabilities or if a plan's assets are less than 90% of current liabilities for two of the last three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

Current liability is also calculated to determine whether a plan sponsor will pay a $19 per participant flat rate premium tax to the Pension Benefit Guaranty Corporation, or whether the sponsor must, in addition, pay a variable rate premium tax based on the plan's unfunded vested benefit liability.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.

What happens if the 30-year Treasury rate is not promptly replaced?

If Congress fails to act, 2004 current liability calculations will be dictated by a maximum rate of 105% of the four-year weighted average of (defunct) 30-year Treasury bonds. Using the rates in effect on January 1, 2003, as a proxy, this would mean that plans would be forced to calculate their current liabilities with a maximum interest rate of 5.82% compared to 7.41% under the ERIC proposal. If this were to occur—

- Current liability calculations would increase by 15% or more.
- Many additional companies, including companies with plans that are in fact well-funded, would become subject to the special funding rules. Both they and those already subject to the rules would experience a spike in their contribution requirements. This will unnecessarily divert money that otherwise would have be spent to build a new plant, buy equipment, pay for research and development, and support jobs.
- Plans that become subject to the current liability funding rules also must notify employees of their underfunded status (even if the plan is not underfunded using reasonable measures), and must pay variable rate premiums to the PBGC. Business operations of these plan sponsors also come under increased scrutiny by the PBGC.

There is no economic justification for these consequences. Thus, it is apparent that affected companies will find their support for defined benefit plans diminished. A strong financial incentive will be created to limit future liabilities. Where cash is in short supply, companies will have no option but to freeze their plans.

There is additional fall-out just from the uncertainty companies currently face. CEOs and CFOs need to know <u>now</u> whether they will be able to purchase a new plant and equipment, to invest in research and development, and to accomplish other vital business objectives.

Consequences of the funding squeeze, caused in part by the continued reliance on the 30-year Treasury rate, already are occurring. A recent survey by Deloitte & Touche indicated that more than four out of ten defined benefit plan sponsors are either making or are considering making fundamental changes to their defined benefit plans. About a quarter of those making or considering changes either already have or are inclined to freeze benefits in the plan.

Action on a replacement rate is needed <u>now</u>. Analysts already are steering investors away from companies with a cloudy contribution forecast. Action by the end of the second quarter, after which planning for 2004 becomes critical, is vital. Delay means damage to plans and their participants, damage to companies, and damage to companies' ability to fuel economic recovery.

Why should a composite corporate bond rate be selected as the replacement for 30-year Treasury rates?

The current liability funding rules are designed to shore up funding in a plan that would have a serious shortfall if it were to terminate and purchase annuities to provide benefit payments. Thus, as the GAO reported less than two weeks ago, "the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices and not be subject to manipulation." (GAO–03–313)

Insurance companies tend to invest in long-term corporate debt. Therefore, a composite corporate bond rate will track changes in annuity purchase rates.

ERIC'S composite rate is composed of high-quality, long-term corporate bond indices. High quality (generally the top two quality levels) provides a reasonable level of security for pension plan sponsors to defreeze their liabilities.

ERIC's composite rate indices also are comprised of bonds with average maturities of 25–30 years (implying durations of 10–12 years), which corresponds to the typical duration of pension plan liabilities.

When the 30-year Treasury bond rate was selected as a compromise basis for the new pension funding rules established in 1987, Treasury rates were closer to corporate bond rates than they are today. Moreover, mortality assumptions in use at the time were outdated, so having an interest rate that was overly conservative made sense.

The composite corporate bond rate in the ERIC proposal is based on indices that are published by major investment houses, based on disclosed methodology, and publicly available. The composite rate is based on information familiar to plan actuaries; it is simple for plans to implement; it is transparent, and it is strongly immune from manipulation.

What about mortality assumptions?

Under current law, Treasury is required periodically (and at least every five years) to review the mortality table required for current liability funding calculations and to update the table as appropriate to reflect the actual experience of pension plans (including permitting plan-specific adjustment factors such as employment classification, lifetime income, and other relevant demographic factors) and projected trends in such experience. An update in the required table is overdue.

ERIC recommends that the use of the RP 2000 Combined Mortality Table, produced by the Society of Actuaries based on a large study of pension plan experience, be required for funding and variable rate premium purposes at the time the composite rate becomes effective. Use of the new table will have the effect of *increasing* current liability calculations for most plans, partially offsetting the effects of adopting the composite corporate bond replacement for the 30-year Treasury bond.

ERIC proposes no changes for mortality assumptions for lump-sum distributions, since they already are being updated under a separate provision of law.

What about lump sum distributions?

It is important that the lump sum discount rate reflect the plan's discount rate. Any disconnect between the lump sum rate and the funding rate will cause plan distributions to either exceed or fall short of estimates used in the plan.

Today's low rate also presents participants deciding between a lump sum distribution and an annuity a choice that is overwhelmingly weighted toward the lump sum. This is in direct contravention of long-established policy that the choice should be economically neutral. As use of lump sums increases, fewer joint and survivor benefits are selected, adversely affecting long-term participant security. In addition, the plan's funding level is adversely impacted.

- Lump sums paid under a defunct Treasury rate are, in fact, windfall benefits that have damaging side effects for long term retirement policy and for the company sponsoring the plan.
- Elderly widows and widowers and others who outlive their assets and have no retirement income stream other than Social Security constitute one of the most vulnerable pockets of poverty today. The current lump sum structure will increase the number of spouses and others left adrift in the future if that lump sum is dissipated.
- Actuarial estimates indicate that a lump sum benefit under the current inappropriate discount rate increases the cost of the benefit to the plan by 17–40%. Many plans cannot absorb these costs and have been freezing or curtailing benefits. Thus, while some current retirees receive a windfall based on an anomaly in the government debt structure, future retirees will receive reduced benefits overall.
- Finally, Internal Revenue Code section 417(e) not only dictates the minimum lump sum rate, but also the rate that regulations encourage companies to use as the interest credit rate in cash balance plans. Thus, maintaining an artificially low lump sum rate for some current retirees means that millions of participants in cash balance plans are losing benefits compared to what they would be earning if the rate were rational.

ERIC proposes that the new interest rate be phased in over a three-year period. The three-year phase-in will align the two rates over time while ensuring that the shift from a defunct 30-year Treasury rate to the composite rate will not have abrupt effects on participants at or very near retirement.

Historically, the lump sum discount rates have averaged about 7%. Today's mandated rate is 4.92%. Under the ERIC proposal, if current rates remained in effect without change, this would gradually increase to a level of about 6.23% over a three-year period—still short of historical averages. The phase-in is designed to roughly approximate normal fluctuations of interest rates in a given year. Thus the changes would be within the margins of change that already occur on a year-to-year basis. In addition, in the second and third years, lump sums of many employees would increase from estimates made today because additional years of age and service would be included in the calculation.

What's wrong with selecting another government rate or a yield curve instead of a composite corporate bond rate?

Any other government rate is going to suffer from the same weaknesses as the 30-year Treasury rate—any relation to annuity purchase prices will be tangential or accidental. Indeed, as the GAO noted (p. 5), "Treasury rates' proximity to group annuity purchase rates might be adversely affected if investors' demand for risk-free securities increases, causing Treasury rates to decline relative to other long-term rates."

Government rates reflect the government's cost of borrowing, not the rate of return on an insurance company's portfolio. Thus they inherently lack relevancy for the purpose at hand.

Corporate bond yield curves might enable a plan to more closely approximate its group annuity purchase rate. However, the extra precision involved is outweighed by several drawbacks. For example:

- There has been little public discussion of a yield curve, a complicated proposal. Adequate consideration of a yield curve between now and July, when a replacement for 30-year Treasuries must be in place, could not occur. It would need substantially more time for debate and analysis. There are a number of highly technical issues involved in switching to a yield curve that have not been explored or addressed.
- Companies already unsure of their cash flow situation will be thrown into even greater confusion, to the detriment of their ability to participate productively in the economy.
- Since it would make no sense to average a yield curve over four years, an annual rate likely would be used. Unless some other "smoothing" mechanism is devised, this will substantially increase pension funding volatility.
- In addition to decreasing pension funding volatility, the current averaging mechanism gives plan sponsors the ability to estimate funding obligations well in advance of the year for which they are due. Basing contributions on an unknowable "spot rate" decreases the ability of sponsors to plan capital commitments.
- Introducing volatile, unpredictable cash flow requirements is a significant burden on plan sponsors. As a result, maintaining a defined benefit plan will become less and less economically feasible for more companies. *It would be impossible for Congress to overestimate the negative impact of turning at this point in time to a pension funding system that increased the volatility and unpredictability of required pension contributions.*
- A yield curve would likely increase required contributions in plans with large numbers of retirees. This could cause very severe economic hardship for those companies.
- A yield curve, combined with the current law deduction limits, would result in less ability for a plan sponsor to fund the plan while participants are younger because it would delay the ability to deduct maximum contributions to periods when the workforce is more mature and declining, and when the company may face new or different economic pressures. It would, in effect, negate some of the good of the Grassley-Baucus amendment in EGTRRA, which phases out deduction limits that had a similar effect of delaying funding over the past decades.
- If a "precise" interest rate such as a yield curve is mandated, a precise mortality assumption also must be considered. Otherwise, industrial plans whose participants have shorter life spans will be required to excessively fund their pension plan. However, such use of such an assumption is likely to be controversial and will require additional discussion, as it will have different impacts on different plans.
- It is unclear how a yield curve would be applied for purposes of lump sum payments, raising a host of additional issues.
- A yield curve is likely to be far less transparent than a composite index; it may be more vulnerable to manipulation; it will be more difficult for the government to police, and it certainly will be more complicated.

A yield curve may impose these drawbacks on the defined benefit system for no real long-term gain over the more simple approach of a composite corporate bond rate.

What can Congress do to help?

Besides prompt enactment of a replacement for 30-year Treasury bond rates, Congress has important opportunities to improve the climate for defined benefit plans.

- Congress can provide for additional stability in companies' funding requirements by enacting ERIC's proposals regarding the volatility and quarterly contribution rules.
- Congress can also provide for increased deductibility for voluntary contributions made in excess of the current required amounts.

Should Congress be concerned about allegations that the PBGC is in trouble?

The short answer is, "No." Congress should monitor the financial status of the PBGC, but should recognize that the PBGC's funded status is better than it has been for most of its existence. It is in fact not in trouble and appears readily able to weather the current economic slowdown.

Should long-term problems emerge, there will be ample time and resources to address PBGC issues, unless short-sighted measures drive PBGC's premium payors away from the defined benefit system.

The loss of the PBGC's surplus should not be a surprise in the current economic circumstances and is, in itself, not a cause for alarm. Indeed, given the requirement in ERISA sec. 4002 that the PBGC "maintain premiums established by the corporation . . . at the lowest level consistent with carrying out its obligations under this title," maintaining a surplus might be in violation of the corporation's charter.

The economic health of the PBGC is determined not by whether it has a surplus or deficit at any point in time but by its ability to pay benefits to participants of plans it trustees. The PBGC has sufficient assets to pay benefits for the foreseeable future. In fact, the PBGC has operated successfully in a deficit situation for most of its history. (see chart)

The real security of the PBGC lies not in imposing new rules that force cash-strapped companies to choose between survival and putting more money into their pension plans. It lies in fostering a vibrant system with lots of companies maintaining defined benefit plans on which they pay premium taxes to the PBGC.

We appreciate the opportunity to appear before the Committee and will be pleased to respond to questions and engage in further discussions either at or after the hearing.

Statement of Jeremy Gold, New York, New York

Recommendation

I propose that the ERISA Current Liability be computed using discount rates that are directly and simply related to the Treasury yield curve. I identify two possible formats: i) a constant "spread" above the Treasury yield curve, expressed in basis points, e.g., the Treasury yield curve plus 50 basis points; or ii) the Current Liability may be set equal to a constant percentage (a "multiplier factor") of the principal value determined using the Treasury yield curve with no spread, e.g., 90% of the principal value computed using the curve.

These two formats are similar in substance and effect. A 50 basis point spread is approximately equal to a multiplier that is between 90 and 95%.

Although ERISA rules for funding and for lump sum payments to individual participants have been linked historically by their common reference to the 30-year Treasury bond, my commentary addresses the issue of the Current Liability (a funding measure) only. I would be happy to comment on lump sum payments at another time.

Structure and Level

Almost all of my recommendation deals with issues of **structure**. These are distinct from what I call issues of **level**. I mention below several objective criteria for **structure**; basing the Current Liability on the Treasury yield curve meets these criteria, while basing it on corporate rates or annuity purchase rates does not. With the economically sound building blocks provided by the Treasury curve, legislation may allow for pragmatic adjustment of the **level** of the Current Liability. For example, legislation could specify that the Current Liability is the discounted value based on the curve plus 50 basis points, or that it be 90% of the discounted value based on the unadjusted Treasury yield curve. For a given set of underlying cash flows, a high value (a high level) for the Current Liability is produced by a *strict* standard; a low value or level is produced by a *lenient* standard.

Although many of those who offer testimony in this matter are primarily concerned with issues of level, they will argue in terms of both level and structure. Thus, for example, one may recommend Treasury rates because the Treasury market is very liquid (a structural matter) or because Treasury rates are low (i.e., a strict level). This is unfortunate because we can gain a great deal by a careful separation of these issues. The long-term rationality and efficiency of the pension system is highly dependent on a well-defined structure. The immediate needs, however, of all constituent parties are closely related to the strictness of the Current Liability measurement. A strict standard will immediately stress the pension plans that are weakly funded by weak sponsors. A lenient standard may help weaker companies and their sponsors over the near term, and may be necessary in these difficult times. Over the long run, lenient standards burden today's strong companies and threaten the plan participants, taxpayers and the PBGC of tomorrow.

The structural basis of the Current Liability is the mechanical process that turns market rates and measures into the discounted liability value. A sound structure will incorporate three critical features: transparency, objectivity and hedge-ability. The present statutory basis fails on all criteria.

Current Liability and the Treasury Yield Curve

Defined benefit pension plans promise future cash flows to participants. At any time, some of these promises have already been earned by participating employees (accrued benefits). The Current Liability is defined by ERISA as a measure of the value of these accrued benefits. This measure entered ERISA via OBRA '87, a public law, was amended by RPA '94, and by JWCCA '02. The liability cash flows are discounted to arrive at their present value. For 2002 and 2003, the discount rate is no greater than 120% of a weighted average of real and virtual 30-year bonds over a four year period. This definition is complicated, out of touch with current market values of similar promises, opaque, and generally not hedge-able.

Despite the shortcomings of the measure, the concept of a Current Liability representing the value of accrued benefits is very important. When we compare the market value of plan assets to a market-based valuation of the Current Liability, we have taken the *single most important* measure of the financial status of that pension plan. This single measure can provide valuable information to plan participants, investors in the corporation that sponsors the plan, and to the public—especially to the PBGC who must underwrite the financial health of the plan in order to protect the participants.

The market-based measure of the Current Liability, in the context of the PBGC guarantee, can best be accomplished using the Treasury yield curve. Although there are some practical problems with every potential measure[1], the problems associated with other measures dwarf those of the Treasury yield curve. The shortcomings of other measures are discussed briefly below.

The Treasury yield curve is visible every day in markets all over the world. These markets (particularly those open in the U.S. during working hours) are extremely liquid and transparent and objective. Numerous other securities including interest rate derivatives, swaps and corporate bonds are priced in relation to the Treasury yield curve. This means that the cash flows that underlie the Current Liability may be measured and hedged with great accuracy.

The Importance of Hedge-Ability

The importance of transparency, liquidity and objectivity offered by the Treasury yield curve (in comparison to all other potential measures) should be obvious. The importance of hedge-ability may be less obvious. Many of my fellow actuaries have limited appreciation for this issue. Actuaries use statistical models to develop distributions of possible future outcomes. Among the variables whose outcomes they analyze in this fashion are future asset values and interest rates. Actuaries often argue that they need to use artificial (i.e., non-market) asset values and liability discount rates so that the (artificially-measured) funding status is rendered more predictable than the underlying uncontrolled market values.

Thus actuaries strive for predictability in the face of volatile markets. They have yet to appreciate this: "volatility is a property of markets; it is not a disease for which actuarial and accounting treatment is the cure."

Modern finance has taught many of us that hedging is the far far better way to cope with such volatility. Whereas artificial actuarial values paper over volatility, hedging allows the risk bearer to accept, dispose or otherwise manage risk exposure and its impact.

As pension accounting becomes more transparent, as it must and will in the near future, hedging will be the mechanism of choice for managers of corporate pension

[1] In the Treasury yield curve case we can note that some benefit cash flows occur after the longest outstanding Treasury securities mature and that liquidity premiums differ between "on-the run" and "off-the-run" issues.

plan exposures. As the statutory basis for funding becomes more transparent, as it must in the near future, hedging will be the mechanism of choice for managers of corporate pension plan exposures. The old approach, wherein the actuary smoothed over the financial realities, shall pass.

The "Spread" or the "Multiplier Factor"

The primary thrust of my comments is aimed at the structure of the current liability measure. Thus I stress transparency, objectivity and hedge-ability. While the structure may be of great importance in the long run (a good structure promotes market efficiency, fairness among plan sponsoring companies, and rational management of pension risks), the level of the Current Liability is of the utmost importance today; it will have an immediate impact on the solvency of the PBGC, the cash flow obligations of plan sponsors and the public's sense of how well we have all dealt with what some refer to as a "crisis."

To protect the virtues of good structure for the long run, we must separate the level issue from the structure. Many of the participants in the current debate have sacrificed structure in order to abet their arguments in re level. Those who have suggested averaging rates, annuity measurement schemes, and the use of corporate bonds (rather than Treasuries) make structural arguments but their motivation is often based on level.

Level is important and urgent. I recommend a system that allows Congress to address the level issue directly and transparently. I propose that the measurement system incorporate only one level setting dial. This dial may be effected in one of two fashions:

1. Built on the solid structure of the Treasury yield curve, we can add a constant "spread" in interest rates. A strict standard would incorporate a small spread, perhaps 25 to 50 basis points. A more lenient standard could use a greater spread. The effect of the spread is to lower the current liability and thus allow for any level of minimum funding desired. Those who favor the use of double-A corporate bonds might achieve the same general level by using the Treasury curve plus 100 basis points. While I would like the spread to remain constant (i.e., set by statute), a workable system could delegate the regular determination of the spread to the regulatory agencies. The Treasury curve with a spread remains objective, transparent and hedge-able.
2. Using the Treasury curve with a zero spread, we can multiply the resulting principal value by a "factor" designed to accommodate valid concerns about the level of the measure. Roughly speaking, a factor of 90% to 95% would have about the same impact as a spread of 50 basis points. This approach remains objective, transparent and hedge-able.

Although it is possible to compound the effects of a spread and a multiplier factor, the simpler the system is, the more benefit we will get from the soundness of the structure. Each adjustment tool—each degree of freedom—weakens the structure. We must be able to address the issue of level, but we should do it with the minimum number of minimally invasive tools. That minimum number is one. Use a spread or use a factor. Resist the temptation to fine tune the process with compound control mechanisms.

Undesirable Alternative Measures

The current system is undesirable in at least two ways—failure to use the whole curve and averaging over time. The four-year averaging of 30-year bonds was adopted to reduce market volatility and to make the resulting measure more "predictable" in the actuarial sense. In a financial world that is progressively more transparent and market-oriented, this averaging is self-defeating. It renders hedging (and rational risk management) impossible.

The use of a corporate yield curve, while far superior to the current system, is inferior to the Treasury-based recommendation that I have made. Corporate bond measures are always more subjective and less transparent than Treasury measures. Many corporate bonds are issued with call provisions that are inappropriate for the measure of pension liabilities; adjustments to neutralize such provisions are always technical, complicated, and at least slightly subjective. Additionally, promises made by the PBGC are backed (in spirit if not in statute) by the U.S. government. Promises made by the U.S. government and its agencies are more highly valued by the capital markets than are the promises made by any corporation.

The private annuity market for pension plan terminations is an exceptionally poor basis for statutes relating to the funding of pension plans covered by PBGC guarantees. Whereas Treasury securities trade in the hundreds of billions of dollars every day, the private annuity closeout business amounts to less than two billion dollars annually. In the last several months the PBGC has acquired liabilities representing a decade of transactions in the private annuity market. The market for any such closeouts in excess of ten million dollars consists of an oligopoly of mildly motivated competitors. The "sweet spot" for such placements is in the neighborhood of one hundred million dollars; a handful of transactions may reach this size annually. In this range, a moderately competitive group of companies will offer effective rates that might exceed Treasury rates. For smaller placements, much lower (after expenses) rates apply.

Annuity pricing is also problematic in that insurance companies combine their gross interest rate with assumptions concerning mortality, retirement ages, etc., as well as with loadings for profit and expenses. These demographic assumptions are commonly much stricter than those used by the plan actuary under ERISA. Combining an insurer's gross interest rate with the plan's regular actuarial assumptions will severely understate the annuity purchase price.

Timing

Despite my admonitions, the issue of level is critical today and we must be willing to compromise to avoid jolts to the system that may be so damaging in the short run that any long run structural benefits are lost.

It will be necessary to allow a transition to any new standard. I suggest two possible ways that this might be accomplished:

1. Commence with a large yield spread (or a low multiplier) for the year 2004. If, for example, 2004 used The Treasury yield curve plus 200 basis points, 2005 might use the curve plus 150, 2006 curve plus 100, 2007 and thereafter curve plus 50. A similar result might be obtained using the Treasury curve with no spread and a multiplier of 65% in 2004 increasing to 95% for 2007 and thereafter.
2. Blend the ultimate approach with the current system. In 2004, compute a value based on the same rule as 2003. Compute as well a value based on the Treasury curve (perhaps plus 50 basis points). The Current Liability for 2004 would be 75% of the first value and 25% of the second. In 2005, after similar computation, the Current Liability would be 50% of the first and 50% of the second value. By 2007, we would use the Treasury curve.

Some have contended that actuarial computer programs may have difficulty implementing a yield curve approach. With all the technology available today, this is something of a red-herring. No actuary or firm serving substantial clients would be unable to implement the yield curve approach for 2004. Once the future cash flows based on accrued benefits are known, the liability may be computed in less than 15 minutes using a spreadsheet program and a published yield curve. Nonetheless, it is possible that actuaries serving only small clients may have some difficulty. Certainly a deferral of application until 2005 may be accommodated for pension plans with fewer than 100 participants.

Thank You

Thank you very much for the opportunity to express my views. I would be happy to respond to questions or to provide additional material and discussion upon request.

I enclose the short article "How to Stop the Insanity" soon to be published in the Pension Section News of the Society of Actuaries.

How to Stop the Insanity!

by Jeremy Gold

At the 2002 Enrolled Actuaries Meeting, Donald Segal and Tonya Manning asked ERISA authorities to "Stop the Insanity." In the authors' response to comments on our article "Reinventing Pension Actuarial Science," Larry Bader and I have said that funding rules require societal, or political, judgments. In this article, I try to identify and delimit, the public's interest in defined benefit plan funding. Thus, for the time being, I put aside the pursuit of a new theory of pension actuarial science in favor of a practical proposal to Stop the Insanity.

As Segal and Manning have documented, twenty-nine years of ERISA have resulted in a chaotic deluge of overlapping, often contradictory, measurements and restrictions designed to regulate the funding of qualified defined benefit plans for U.S. employees. We may understand such rules as the expression of the public's interest in what otherwise would be a matter of private contracts between employers and employees. Although the public interest in these matters is legitimate, we can do the public will in a fashion that will Stop the Insanity.

Public interest in the funding of private defined benefit plans comprises two issues:

- Funding should be sufficient to secure promises that have been made by employers and earned by employees—i.e., accrued benefits, measured at market values.
- Tax-deductible contributions should be limited. Such limitation may also be defined in relation to the value of accrued benefits.

The public does not have an interest in:

- Patterns of contributions over time, although this may be important to plan sponsors and their constituents.
- Normal costs.
- Gain and loss amortization.
- Past service costs and amortizations.
- Interest on liabilities.
- Expected returns on assets.

I believe that the six bullets above, the basics of the traditional actuarial funding processes that underlie ERISA, contribute to the Segal-Manning Insanity. Pre-ERISA, these components helped the actuary rationalize the sponsor contribution budgeting process. When the public chose to intervene, it framed the problem in terms of these components and attempted to control funding outcomes by controlling these inputs. Much of the insanity arose in response to undesirable outcomes. Thus, for example, the PBGC saw the need to define and measure the Current Liability after plans that met ERISA's minimum funding rules failed to achieve adequate funding levels.

My Sane proposal defines two simple limits: a minimum (sufficiency level) below which contributions are required and a maximum (excess level) above which no contributions are allowed. Between these levels, the public has no interest and plan funding is entirely discretionary. Actuaries may design funding schemes therein, employers may negotiate with employees and their representatives therein, stockholders and lenders may argue with management therein. The public does not care.

My proposal is the ultimate safe harbor. Within the harbor, actuaries and plan sponsors may use the elemental actuarial building blocks much as a sailor uses the tiller and the positions of sails to guide a boat. As long as the boat neither runs aground nor heads out to the open sea, the Coast Guard can rest easy.

The public must choose its measures of sufficiency and excess very carefully. Although setting the levels will be inherently political, the liability measure should be financially sound, transparent, and objective. Discounting the cash flows implied by benefit accruals to date at the Treasury yield curve meets these tests. Once set, the measures should be administered with minimal discretion and subjected to minimal political interference. Most of the political debate should be focused on setting the heights of the lower (sufficient) and upper (excessive) bars, each defined in terms of the ratio of market-valued assets to the objective liability measure.

Suppose, and I really mean this as an example and not as a recommendation, that the lower bar is set at 100% and that any shortfall must be one-third funded currently. The shortfall has no history and no amortization schedule. If the plan is three million dollars short, the sponsor must fund one million dollars currently regardless of whether it was underfunded or overfunded last year. There is no schedule for the other two million. If the plan remains underfunded next year, the sponsor must contribute one-third of the shortfall determined at that time. I would expect PBGC premiums to be collected from all qualified plans with a basic per-capita amount for plans that are sufficiently funded and increased amounts for plans in shortfall. Shortfall plans might be further restricted from making benefit increasing amendments.

The tradeoff for the rigorous attack on poorly funded plans is the freedom offered to the great majority of well-funded plans. This combination should provide substantial incentive to sponsors to manage the asset/liability positions of their plans prudently as well as to exercise caution in granting benefit increases.

Suppose, again as an example not a recommendation, the upper bar is set at 150%. The sponsor of a plan that is one million dollars short of this ceiling would be permitted to contribute and deduct one million dollars if it desired. From the public perspective, it seems to me that plans funded above the upper bar should be free to recoup such excess funding without excise taxes and without strings on the redeployment of such monies (after payment of appropriate income taxes). The IRS may want to limit this practice for companies that appear to be taking undue advantage.

The initial bar-setting process may be as technically complicated and as political as the public will choose to demand/tolerate. Congress will be the arena for the bar-setting process; the regulatory agencies will administer that which Congress devises. Congress might choose to assign authority for lower-bar issues to the DOL and the PBGC and upper-bar issues to the IRS.

An example of a technical, complicating issue that lies within the initial process: those who share my financial economics perspective may want the lower bar to be set to recognize the nature of the plan's asset/liability mismatch. Plans invested in a liability-matching fashion might have a lower bar set at 95%, while poorly matched plans might face a bar set at 115%.

A second example: if Congress is concerned about tax losses attributable to excessive inside build-up as well as excessive contributions, they may wish to define an upper-upper bar above which funds would be mandatorily reverted and taxed. Congress may also deem it necessary to limit tax deductions for small plans that principally serve as tax shelters for owner-employees or other narrow groups.

I have tried to suggest a practical response to the Segal-Manning plea for sanity. The success of such a simplification scheme requires that:

- The basis for liability measurement be scientific, objective and market oriented. The thumb should be off the scale with respect to measurement.
- Setting the levels of the lower and upper bars should be as simple as possible, but no more so.

Looking beyond the immediate and practical, I hope that the inner harbor will provide substantial room for pension actuarial science to evolve, free of much of the regulation that has stunted its growth over the last three decades. We really do need to revisit and revitalize our science.

Statement of March of Dimes

On behalf of 1,500 staff and over 3 million volunteers nationwide, thank you for the opportunity to submit the March of Dimes' views on funding challenges being faced by the employer-sponsored defined benefit pension system. The March of Dimes is a nonprofit organization working to improve the health of mothers, infants and children by preventing birth defects and infant mortality through research, community services, education, and advocacy. Of relevance to this hearing, the March of Dimes sponsors a defined benefit pension plan for its employees, which serves as an important tool for attracting and retaining high-caliber employees who are committed to the mission of the March of Dimes. If retirement plans such as the March of Dimes defined benefit plan are to remain viable as a long-range planning tool providing retirement income security for current and future employees, Congress must take quick action to relieve the very real funding pressures now faced by these plans.

Congress has long recognized the importance of helping Americans achieve retirement income security, and defined benefit plans, in particular, offer a number of features that are critical components of retirement security. Under defined benefit plans, benefits are generally funded by the employers and the employer bears the investment risk that plan assets will be adequate to pay benefits earned under the plan. Importantly, benefits are offered in the form of a life annuity, which protects participants and their families against the risk of outliving their retirement income.

Like many other employers, the March of Dimes is concerned about funding pressures that are straining the stability of the nation's defined benefit pension system. One of the primary sources of this funding pressure is tied to the required use of an obsolete interest rate—the 30-year Treasury bond rate—as the benchmark for a variety of pension calculations, including those involving pension liabilities, pension insurance premiums, and lump-sum distribution calculations. Fortunately, there are positive steps that Congress can take to address these funding pressures and enable employers, including the March of Dimes, to provide financially sound pension programs. First and foremost, there is an urgent need to enact a permanent and comprehensive replacement for the 30-year Treasury bond rate, which can be achieved by promptly enacting the provision included in the Pension Preservation and Savings Expansion Act (H.R. 1776), recently introduced by Representatives Portman and Cardin. Their proposal offers a balanced and carefully structured solution to a complicated and urgent pension funding problem. The March of Dimes commends their leadership in offering a bipartisan and workable solution to this pressing matter, and we urge Congress to act quickly to provide this relief to defined benefit plans and to protect the pensions of current and future plan participants.

Conclusion

Mr. Chairman and Ranking Member McNulty, thank you for calling this hearing to explore this important retirement policy question, and for your efforts to find a solution to the defined benefit funding crisis that will enable American workers now and in the future to benefit from the unique advantages of defined benefit pension plans.

Mayo Clinic
Washington, DC 20036
May 12, 2003

On behalf of Mayo Clinic I am submitting this statement for the hearing record. Mayo Clinic is a multi-specialty integrated medical group practice, with clinics and hospitals in Minnesota, Florida, Arizona, Wisconsin, and Iowa. We are a not-for-profit organization, dedicated to the missions of patient care, education, and research.

Like many other large employers, Mayo has a defined-benefit pension plan available to substantially all our employees. The plan currently covers about 34,600 current employees and 3,200 retirees. The use of the 30-year Treasury Bond as a benchmark for calculating future liabilities is creating a short-term funding problem that has required significant contributions to the fund in the past year, and will require even greater contributions over the next few years. While we are committed to adequate funding of our pension plan, the current liability valuation methodology based on the 30-year bond is creating a short term funding crisis for pension plan sponsors across the country and deserves correction. We need a more realistic valuation methodology that appropriately considers the long-term nature of pension liabilities and the true investment return plan sponsors like Mayo can expect in funding them.

While many large corporations are in positions similar to ours, we want to note for the subcommittee that this is a problem that significantly affects not-for-profit organizations as well. Contributions to the pension plan come out of the funds otherwise used to fund our tax-exempt missions of patient care, education and research. Thus, a smoother and more predictable schedule of pension contributions is extremely important in assuring uninterrupted education and research activities.

We therefore urge the subcommittee to consider legislation to correct the current valuation methodology for determining pension liabilities. At a minimum, the current temporary provision should remain in place while a permanent solution can be determined—one that will allow a more stable and predictable schedule of contributions over time.

Thank you for your attention to this important issue.

Sincerely,

Bruce M. Kelly
Director of Government Relations

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