Testimony of J. Mark Iwry[1] and Jack VanDerhei[2]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

July 1, 2003

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, we are submitting this joint written statement in response to the Subcommittee's request for additional information and comments for the record regarding two issues that arose during the Subcommittee's June 4, 2003 hearing on defined benefit pension plans.

The first part of this statement, prepared by Mr. VanDerhei, provides requested information regarding the incidence and uses of lump sum distributions from retirement plans. The second part of this statement, prepared by Mr. Iwry, provides requested views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also sponsor "robust" defined benefit plans. Mr. Iwry concurs in the substance of the first part of this statement, and Mr. VanDerhei concurs in the substance of the second part.

I. Data Regarding Lump Sum Distributions and Their Uses

Lump sum distributions (LSDs) may be provided by either a defined benefit or a defined contribution plan. Regardless of the type of retirement plan, participants may be required to take a LSD if the value of the defined benefit accruals or defined contribution account balance does not exceed $5,000. Based on data from the 1996 Survey of Income and Program Participation (SIPP), 40.4 percent of LSD recipients, reported that they were required to take their most recent distribution while the remaining 59.6 percent took the distribution voluntarily.[3]

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[1] Mark Iwry served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. He currently is a nonresident Senior Fellow at the Brookings Institution and a lawyer who has provided legal advice and assistance regarding issues referred to in this testimony. The views expressed in this testimony are those of Messrs. Iwry and VanDerhei alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution, Temple University, the Employee Benefit Research Institute, or to any other organization.

[2] Jack VanDerhei is a faculty member in the Risk, Insurance and Healthcare Management Department, Fox School of Business and Management, Temple University, and research director of the Employee Benefit Research Institute Fellows Program.

3 All data in this statement are taken from Employee Benefit Research Institute (EBRI) tabulations of recently released data from the U.S. Census Bureau -- The Pension and Retirement Plan Coverage Topical Module of the 1996 Survey of Income and Program Participation -- which includes lump-sum data for individuals through 1998. See Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," August 2002 EBRI Issue Brief and Craig Copeland, "Lump-Sum Distributions: An Update," July 2002 EBRI Notes.

Excluding dollars left in the plan of a previous employer (an option which will not be available to all participants), 14.3 million persons age 21 and over reported receiving a LSD from a previous job.[4] The distribution of amounts (in nominal dollars) was skewed with a median of $5,000 and a mean of $15,402. Slightly more than 1/3 of the accounts were less than $2,500 and slightly less than 10 percent were greater than $50,000.

It is possible to identify five distinct uses for the LSDs:

1. Tax-qualified financial savings (including other employment-based retirement plans and IRAs)
2. Non-tax-qualified financial savings (e.g., savings accounts)
3. Debts, businesses and homes
4. Education expenses
5. Consumption (including purchase of consumer items and general everyday expenses)

"Leakages" from the retirement system are often defined as any amounts that either do not remain in the previous employer's plan or are rolled over into the first category above. However, it is possible in specific situations that uses in categories 2, 3 and 4 above may enhance the overall financial situation of the participant sufficiently that the eventual retirement wealth is not decreased. By contrast, most analysts would agree that expenditures in category five (consumption) are quite likely to lower participants' overall retirement wealth.

The good news based on these data is that the propensity to use these distributions for consumption has decreased over time: the proportion of LSD recipients using any portion of their most recent distribution for consumption was 20.3 percent for amounts received before 1980, 17.6 percent for the period 1980-1986, 14.4 percent for the period 1987-1993, and only 12.2 percent for the most recent period covered by the data, 1994-1998.[5]

The data also reveal a very strong impact of both age and the amount of distribution on the likelihood of using the entire portion of the most recent distribution for tax-qualified financial savings. Participants ages 21-30 at the time of the most recent distribution used the entire distribution for this purpose only 23.5 percent of the time. This number monotonically increases with age until it

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This research updates earlier studies done using the Employee Benefits Supplement to the April 1998 and 1993 Current Population Survey (CPS). For an analysis of the incidence of LSD rollovers as reported in the CPS in 1988 and 1993 see Leonard E. Burman, Norma B. Coe, and William G. Gale, "Lump- Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research," National Tax Journal, September 1999, pp. 553– 62.

4 This includes survivors (beneficiaries of deceased participants).

5 Some of the most recent decrease may be due to the imposition of the 20 percent withholding tax imposed by The Unemployment Compensation Act of 1992.

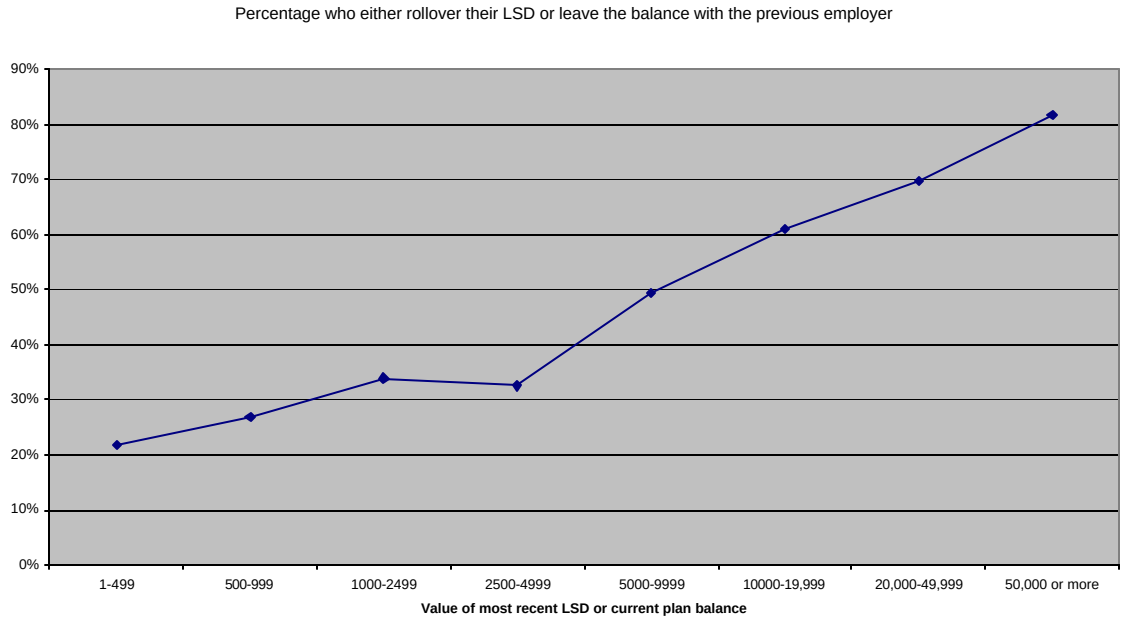
reaches a maximum of 53.1 percent for participants age 61-64 and then decreases to 44.7 percent for those age 65 and older.

A similar relationship holds for the amount of the most recent LSD. When the amount is less than $500, only 16.7 percent of the accounts are entirely used for tax-qualified financial savings. The likelihood increases dramatically after the $5,000 threshold is reached: the percentage is 36.6 percent for amounts between $5,000 and $10,000. It continues to increase as the account balance increases and 70.7 percent of the accounts with a value of $50,000 or more are used exclusively for this purpose.

There are two additional aspects of retention of retirement savings that may be considered for defined contribution plans given the nature of the SIPP database. The first considers whether plan participants elect to retain their account balances with their former employers when given the chance (versus taking it as a LSD). As expected, the likelihood of retaining these amounts with the former employer increases with the size of the account: for accounts less than $500, only 6.1 percent choose this option; however, for accounts of $50,000 or more the percentage increases to 37.4 percent.[6]

The second aspect, and the one that may be of most relevance for defined contribution plan participants, is the percentage of participants who keep their account balances in tax-qualified savings by either rolling over their LSD to tax-qualified savings or leaving the balance with the previous employer. The following figure shows that this percentage ranges from a low of 22 percent for accounts of less than $5,000 to a high of 82 percent for accounts of $50,000 or more.

6 A study that examines this retention versus lump-sum distribution behavior using year 2000 data is Fidelity Investments, Building Futures, Volume III: A Report on Corporate Defined Contribution Plans (2001), pages 65-69. The study apparently does not reflect distributions made after 2000 yearend to terminated participants who were counted in 2000 as having retained their account balances in the former employer's plan.



Source: tabulations based on Copeland, August 2002

II. Possible Relief from DC Plan Requirements for Employers That Sponsor Certain DB and DC Plans

Chairman Johnson and Ranking Member Andrews have asked for comments regarding a possible proposal for employers that sponsor both defined benefit (DB) and defined contribution (DC) plans. This proposal has been described in Committee staff's June 16, 2003 communication to the witnesses as "… almost as a reward for having a robust DB plan, that the DC plan would be regulated in a slightly less onerous or difficult way."

As a general proposition, it can be highly advantageous to employees to be covered by both a DB and a DC plan. In combination, the particular strengths typically found in each type of plan can contribute importantly to an individual's retirement security. The advantages of DB plans (as well as DC plans) are discussed in the written testimony that was submitted for the Subcommittee's June 4, 2003 hearing.

The degree to which this is true in any given situation, however, will generally depend on the specific characteristics of the particular plans at issue. The Subcommittee's question, phrased in terms of a "robust" DB plan, seems to reflect this. The value of a DB plan will typically depend on how the particular characteristics of the plan interact with the particular characteristics of the individuals who are covered. The relevant plan characteristics include, for example

- the structure and the level (amount) of the benefit formula, including
    - traditional or hybrid formulas,
    - use of permitted disparity (traditionally referred to as Social Security integration), and
    - final average pay or career average features,
- early retirement and other retirement-related subsidies,
- death and disability benefits,
- the vesting schedule,
- distribution options,
- which employees are and are not covered, and other features.

The characteristics of the employees that may be relevant often include age, length of service with the employer, and earnings, as well as their job classification (including whether their benefits are collectively bargained).

For example, the same DB plan might be "robust" for an older, longer-service individual, to whom it is of great value, while being of little or no value to a young, short-term employee. Even if both employees vest in all of their accrued benefits under the plan, under many plans the value of those benefits in the event the employee's employment terminates can be very different depending on the employee's age.

We would be happy to evaluate and comment on such a proposal; however, the only description of the proposal that has been provided is very general. In order to provide useful comments to the Subcommittee, we would need to understand the proposal more specifically, including clarification of its policy objectives. Whether the proposal would have merit, in our view, would depend in part on which aspects of the current statutory or regulatory provisions governing DC plans would be eliminated or modified, and how; whether the goals of the proposal are to encourage employers to retain existing DB plans or to adopt new ones or both (or whether the proposal has other objectives); and what would be meant by a "robust" DB plan (including the degree of overlap between the employees covered by the DB plan or plans and by the DC plan or plans).

These specifics would make possible an analysis of the merits of the proposal, including

- how it might affect important worker protections;

- the extent to which the possible reduction in requirements for DC plans would be likely to meaningfully increase employers' willingness to adopt or continue maintaining – and employees' demand for – "robust" DB plans and other qualified retirement plans;

- whether, in the aggregate, the expected reduction of benefits or protections in DC plans would be more than offset by the expected increase in benefits or protections in DB plans (taking into account the likelihood that, in response to such a provision, some employers would improve their DB plans, others might adopt new DB plans, and still others would not need to change their DB plans while reducing DC benefits or protections because their DB plans would already be "robust," including the likelihood that some employers in this last category would retain existing DB benefits that otherwise might have been frozen or reduced);

- whether it would represent a cost-efficient use of the tax expenditure;

- whether it would be equitable to employers and employees (including distributional effects);

- whether it would be administrable both for the regulators – whether the Department of Labor and IRS would be able to regulate and enforce compliance effectively – and for plan sponsors;

- its revenue cost, and

- its impact on pension and tax law complexity.