TESTIMONY OF J. MARK IWRY[1]

BEFORE THE COMMITTEE ON EDUCATION AND THE WORKFORCE

UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 29, 2003

Chairman Boehner, Ranking Member Miller and Members of the Committee, I appreciate the opportunity to appear before you to discuss issues relating to underfunding in our private defined benefit pension system and pension funding reforms.[2]

After providing brief background on defined benefit plans, pension insurance, the PBGC, and the taxpayers' investment in the private pension system (part I, pages 1-4 and Appendix A), this written statement reviews recent developments affecting pension funding and pension insurance (part II, pages 4-7) and the often conflicting public policy objectives that need to be reconciled when formulating policy in this area (part III, pages 7-8). Next, the statement turns to two threshold questions – whether legislation is needed in the short term and whether broader, permanent changes to the system are called for (part IV, pages 8-9). The main portion of the testimony then suggests ten specific cautions and considerations to bear in mind when considering longer-term reforms (part V, pages 9-17).

.

I. Background[3]

A. Defined Benefit Plans and the PBGC

The Pension Benefit Guaranty Corporation (PBGC), a federal government corporation created under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), provides insurance to protect the retirement benefits of most participants in tax-qualified defined benefit plans. The PBGC's guarantee generally applies when the plan terminates while inadequately funded and the plan sponsor has failed or is otherwise demonstrably unable to make up the deficiency. PBGC guarantees more than 32,000 defined benefit plans that are

[1] The witness is a lawyer and a Nonresident Senior Fellow at the Brookings Institution. He served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] The majority of this testimony is drawn verbatim from my September 15, 2003 testimony before the Subcommittee on Financial Management, the Budget, and International Security of the U. S. Senate Committee on Governmental Affairs. Several portions of the September 15, 2003 testimony draw heavily, in turn, on my previous testimony regarding the same or similar issues.

[3] Further context regarding the private pension system is provided in Appendix A, which is drawn nearly verbatim from my June 4, 2003 testimony before this Committee's Subcommittee on Employer–Employee Relations.

sponsored by private-sector employers and that cover nearly 44 million workers and retirees.

PBGC pays statutorily-defined guaranteed pension benefits to participants monthly up to specified dollar limits (currently just under $44,000 for pensions beginning at age 65 and significantly less for pensions beginning earlier). If a defined benefit plan terminates without adequate funding to pay promised benefits, and the employer goes out of business or is otherwise financially unable to fund the benefits (a "distress termination"), PBGC generally steps in and takes over trusteeship of the plan and its assets, assuming responsibility for paying guaranteed benefits. In addition, in appropriate circumstances, the PBGC may obtain a court order to involuntarily terminate a plan that the employer has not terminated.

Following a distress or involuntary termination, the plan sponsor and its affiliates are liable to PBGC for unfunded liabilities, and PBGC may place a lien on the sponsor's property for up to 30% of its net worth. An employer that is financially capable of fully funding a plan's benefits when the plan terminates is required to do so (in a "standard termination").

In a sense, PBGC operates as an insurance company for pension plans. However, it has a special public responsibility to protect the interests of plan participants in a social insurance system. The agency has often acted as an advocate for participants' pension interests in negotiating with corporations that are in financial distress regarding pension plan funding and benefits in connection with corporate bankruptcy.

PBGC maintains separate insurance programs for "single employer" plans and "multiemployer" plans, covering about 34.4 million and about 9.5 million employees and retirees, respectively. The separate programs correspond to the somewhat different legal frameworks that apply to the two types of plan.

- "Single employer plans" include the conventional corporate plan sponsored by a single employer for its employees (as well as a plan sponsored by several related employers where the joint sponsorship is not pursuant to collective bargaining).
- "Multiemployer plans" are sponsored by related employers in a single industry where employees are represented by collective bargaining and where the plans are jointly trusteed by representatives of corporate management and of the labor union.

Defined benefit plans cover employees of private-sector and public-sector employers. Plans maintained by State and local governments (and by the Federal Government) for their employees comprise a large portion of the defined benefit universe. However, those plans generally are exempt from ERISA and are not covered by PBGC termination insurance.

The PBGC is funded in part by insurance premiums paid by employers that sponsor defined benefit pension plans. All covered single-employer plans pay a flat premium of $19 per plan participant. Single-employer plans that are considered underfunded based on specified assumptions are subject to an additional variable premium of $9 per $1,000 of unfunded vested benefits.

PBGC's sources of funding are

- the premiums it collects,
- assets obtained from terminated plans PBGC takes over,
- recoveries in bankruptcy from former plan sponsors, and
- earnings on the investment of PBGC's assets.

General tax revenues are not used to finance PBGC, and PBGC is not backed by the full faith and credit of the United States Government. The U. S. Government is not liable for any liability incurred by PBGC.

B. Taxpayers' Current Investment in Private Pensions

It is often observed that if the defined benefit pension funding problem becomes severe enough, PBGC might eventually become unable to pay insured benefits as they come due, and a federal taxpayer bailout might be necessary. By way of context, it is worth recalling that the taxpayers already are partially subsidizing the private pension system, including defined benefit plans, through federal tax preferences for pensions.

Those tax preferences represent a significant investment by the taxpayers. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues -- as having a present value of $192 billion.[4] Of that total, some $100 billion is attributable to defined benefit plans and defined contribution plans other than section 401(k) plans (and the remainder is attributable to 401(k) plans and IRAs).[5]

This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when the contributions and earnings are distributed in the future, whether within or beyond the "budget window" period.[6] Because large portions of the defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant percentage of

[4] Pensions can be viewed as increasing national saving to the extent that the saving attributable to pensions (net of any associated borrowing or other reductions in other private-sector saving) exceeds the public dissaving attributable to the tax preferences for pensions.
[5] Budget of the U.S. Government, Fiscal Year 2004, Analytical Perspectives, Table 6-4, page 112 ("FY 2004 Budget, Analytical Perspectives"). The budget documents also contain other tax expenditure estimates that are based on alternative methods.
[6] FY 2004 Budget, Analytical Perspectives, page 102.

the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

II. Recent Developments Affecting Pension Funding and Pension Insurance

After running a deficit for the first 21 years of its history, PBGC's single-employer program (which accounts for the vast majority of PBGC's assets and liabilities) achieved a surplus from 1996 through 2001. By 2000, the surplus (the amount by which assets exceeded liabilities) was in the neighborhood of $10 billion. Recently, however, PBGC has seen the financial condition of its single-employer program suddenly return to substantial deficit: $3.6 billion in FY 2002 and, according to PBGC, an estimated $8.8 billion as of August 31, 2003 (based on PBGC's latest unaudited financial report). [7]

PBGC's financial condition could alternatively be expressed in percent funded terms – taking PBGC's assets as a percentage of its liabilities. For the purpose of estimating PBGC's funding percentage, it has been suggested that, when PBGC takes into account "probable" future claims, it count not only expected total liabilities but the total assets PBGC would be expected to take over and recover in connection with those claims.

PBGC's financial condition has deteriorated because a number of major plan sponsors in financial distress have terminated their defined benefit plans while severely underfunded. Others may well follow suit. In addition to structural weakness in certain industries, low interest rates -- increasing the valuation of plan liabilities -- and low returns on investment -- reducing plan assets as well as PBGC's own assets -- have contributed dramatically to the underfunding problem.

According to PBGC estimates, its losses might ultimately include an additional $35 billion of unfunded vested benefits that the agency would have to take over if certain plans maintained by financially weak employers were to terminate. (About half of the $35 billion is attributable to plans in the steel and air transportation industries.) As a result, the General Accounting Office has recently placed PBGC's single-employer insurance program on its high-risk list of federal agencies with significant vulnerabilities.[8] PBGC also expects that, by the end of FY 2003, its estimate of underfunding in financially troubled companies will have grown from $35 billion to more than $80 billion.[9]

---

[7] Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Special Committee on Aging, United States Senate, October 14, 2003 ("PBGC October 14, 2003 Testimony"), page 3.

[8] However, the PBGC's assets in the single-employer program exceeded $25 billion as of September 30, 2002 (and are greater now). For some time to come, these assets will be more than sufficient to meet PBGC's current benefit payment obligations and administrative expenses – about $2.5 billion in FY 2003, and expected to increase to nearly $3 billion in FY 2004 – which are partially offset by premium income that is somewhat less than $1 billion a year.

[9] PBGC October 14, 2003 Testimony, page 7.

To help put the amounts into perspective, the total amount of defined benefit pension benefits PBGC insures is approximately $1.5 trillion, and PBGC estimates that total underfunding in the single-employer defined benefit system amounted to more than $400 billion as of the end of 2002. (Before 2001, the previous high water mark in underfunding had been little more than one fourth of that amount, in 1993.) Of the $400 billion, the $35 billion (FY 2002) and $80 billion (FY 2003) figures cited earlier represent estimated underfunding in plans sponsored by financially troubled companies (where PBGC estimates that plan termination is "reasonably possible)."

The downturn in the stock market during the past several years, unusually low interest rates, and the Treasury Department's buyback of public debt and decision to stop issuing 30-year Treasury bonds have contributed in a major way to converting defined benefit plan surpluses into deficits. Significant underfunding has developed because plan asset values have fallen below their levels during the late 1990s, while the present value of plan liabilities has increased because the four-year weighted average of interest rates on 30-year Treasury bonds, used as a basis for valuing defined benefit liabilities, has been at an unusually low level.

The greater likelihood of corporate failures associated with the weak economy also has contributed significantly to this situation. PBGC estimates that half of the underfunding in financially weak companies is attributable to two industries: steel and airlines. Together, these two industries account for nearly three fourths of all past claims on the PBGC while representing fewer than 5% of participants covered by PBGC.[10] For example, in 2002, PBGC involuntarily terminated a plan of Bethlehem Steel Corporation that shifted about $3.7 billion of unfunded liabilities to PBGC. (Reportedly, the plan had been 97% funded as recently as 1999, dropping to 45% by 2002.)

In addition, a fundamental demographic trend has raised the cost of funding defined benefit plans, making them harder to afford: increased longevity combined with earlier retirement. It has been estimated that the average male worker spent 11.5 years in retirement in 1950, compared to 18.1 years today.[11] Of course longer retirements increase plan liabilities because the life annuities provided by defined benefit plans are paid for a longer period.

Increased longevity and retirement periods also mean that the single-sum payments many of these plans offer ("lump sum distributions") are significantly larger, as they generally are based on the actuarial present value of the life

[10] Most of the financial data in this testimony regarding PBGC and its exposure are from recent PBGC testimony:Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Special Committee on Aging, U.S. Senate, October 14, 2003, and Mr. Kandarian's testimony before this Committee's Employer-Employee Relations Subcommittee on September 4, 2003.
[11] See testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation before the House Committee on Ways and Means, Subcommittee on Select Revenue Measures, April 30, 2003, pages 7-8.

annuity. Combined with this is the separate tendency of an increasing number of defined benefit plans to offer and pay lump sums either at retirement age or at earlier termination of employment, or both. The effect is to accelerate the plan's liability compared to an annuity beginning at the same time.

Another trend adversely affecting the system and the PBGC is the gradual decline of defined benefit pension sponsorship generally. (A number of the major factors accounting for the decline are discussed in my June 4, 2003 testimony before this Committee's Employer-Employee Relations Subcommittee.) One effect of the overall decline is the increasing risk that financially stronger plan sponsors will exit the defined benefit system, recognizing their exposure to the "moral hazard" of financially troubled companies adding benefits that they know may well be paid by PBGC. This risk grows as the premium base narrows and as financially strong sponsors find their premiums are increasingly subsidizing the financially weak employers that pose the risk of underfunded plan terminations imposing liability on PBGC.

Combined with these developments is a fundamental structural problem and growth in the scale of the issue. As economic adversity has hit certain industries and companies, and as their ratio of active employees to retirees has dwindled, unfunded pension obligations (as well as other unfunded "legacy costs", chiefly retiree health liabilities) loom larger in the overall financial situation of individual companies and entire industries.

When the pension insurance system was enacted as part of ERISA in 1974, plan liabilities typically were not large relative to plan sponsors' market capitalizations. However, during the ensuing 29 years, pension and retiree health obligations have grown relative to assets, liabilities and market capitalization of the sponsoring employers (and some financially troubled companies now have underfunding in excess of their market capitalization).

Moreover, contrary to what might have been the prevalent expectations in 1974, these economic troubles and associated underfunding have come to affect not only individual companies but entire industries. In view of these fundamental structural developments, the issue no longer is only a pension policy problem; it has become a larger industrial and social policy problem.

These developments have been saddling plan sponsors with funding obligations that are large and -- in the case of the unusually low interest rates and low equity values – unexpectedly sudden. These obligations in turn are hurting corporate financial results. As a result, while some have noted that recent poor investment performance in 401(k) plans should give employees a new appreciation of defined benefit plans, some corporate CFOs have been viewing their defined benefit plans with fresh skepticism. The prospect that more defined benefit plans will be "frozen" (ceasing further accruals under the plan) or terminated is a very real concern. Congress must take it seriously.

Defined benefit plans have provided meaningful lifetime retirement benefits to millions of workers and their families. They are a central pillar of our private pension system.[12] National retirement savings policy should seek to avoid a major contraction in the defined benefit pension system while protecting the security of workers' pensions through adequate funding.

III. Guiding Principles to be Reconciled in Formulating Policy

As suggested, a number of often conflicting public policy objectives need to be reconciled or balanced in responding to this situation. They include the following:

- Provide for adequate funding over the long term to protect workers' retirement security, with special attention to reducing chronic underfunding.

- Take into account the potential impact of very large funding demands on a plan sponsor's overall financial situation and on economic growth (which may suggest, among other things, close attention to appropriate transition rules).

- Minimize funding volatility for plan sponsors so that required increases in funding from year to year are kept on a reasonably smooth path.

- Protect the reasonable expectations of employees and retirees with respect to promised benefits, and, to the extent possible, avoid discouraging the continued provision of benefits. (This may suggest an emphasis on requiring sponsors to fund adequately in preference to direct restrictions on their ability to provide benefit improvements or curtailment of the PBGC's guarantee.)

- Do not penalize the plan sponsors that are funding their plans adequately and that are not part of the problem. Minimize any impact on those sponsors – who are subsidizing the sponsors of underfunded plans -- and, more generally, encourage employers to adopt and continue defined benefit pension plans.

- To the extent possible, avoid rules that are unnecessarily complex or impractical to administer.

[12] For an evaluation of defined benefit plans from a pension policy standpoint, a discussion of the role of these plans in the private pension system, and an analysis of the decline in defined benefit coverage, see Testimony of J. Mark Iwry before this Committee's Subcommittee on Employer-Employee Relations, June 4, 2003, as well as the testimony of other witnesses presented at a hearing of the Subcommittee on that date.

- Be mindful of the impact of rule changes on the federal budget deficit, including the long-term impact that extends beyond the conventional budget "window".

IV. Threshold Questions

Balancing these objectives is exceedingly difficult. In considering how best to do so, it is worth addressing two threshold questions.

First, should the situation be allowed to right itself without legislation? Are the problems affecting pension funding and PBGC's finances so clearly cyclical that they can reasonably be expected to solve themselves with continued economic recovery, rise in equity values, and rise in interest rates?

In my view, the answer is no. Plan sponsors need some degree of short-term, temporary funding relief now, largely because of the distortions in the level of the 30-year Treasury discount rate. As noted, that rate has been unusually low, affected by buybacks and Treasury's decision to discontinue issuance of the 30-year Treasury bond. Accordingly, the temporary relief for employers enacted for 2002 and 2003 in the Job Creation and Worker Assistance Act of 2002 -- allowing plan sponsors to increase their pension funding discount rate from 105% to 120% of the four-year weighted average of the 30-year Treasury rate -- should not be allowed to expire at the end of 2003 without an appropriate legislative replacement.

Earlier this month, the House passed H.R. 3108 (the "Pension Funding Equity Act of 2003", sponsored by Chairman Boehner and cosponsored by Ranking Member Miller and Rep. Johnson of this Committee), which would not only continue the temporary funding relief but expand it significantly. For purposes of determining the pension funding discount rate (and PBGC variable-rate premiums) for 2004 and 2005, the bill would replace 105% of the four-year average of the 30-year Treasury rate with the four-year average of interest rates on amounts conservatively invested in a blend of long-term corporate bonds.

The Senate Finance Committee has reported out a bill (the National Employee Savings and Trust Equity Guarantee Act, or "NESTEG") that includes a similar change not only for 2004 and 2005 but also for 2006, and that would go much further in other respects.[13] In addition to proposing certain more permanent changes to the funding rules, NESTEG would waive the "deficit reduction contribution" ("DRC") requirement for 2004-2006 for any plan for which a DRC was not required for the 2000 plan year. The DRC, which calls for accelerated funding of plans that are essentially less than 90% funded, is the linchpin of the funding requirements for underfunded plans and of the 1987 and 1994 pension funding reforms.

[13] As of the date of this hearing, the Senate Health, Education, Labor, and Pensions Committee is scheduled to mark up a bill that would also provide short-term pension funding relief.

The Administration has objected strongly to this proposed three-year waiver of the DRC[14] (which is not included in the legislation passed by the House) on the ground that it would expose workers and the PBGC to unnecessary risk of underfunding in the highest-risk plans. As originally contemplated, the provision would have applied to a more narrowly defined set of plans, but the proposal was expanded to include all plans for which a DRC was not required in 2000. According to PBGC, nearly 90% of the underfunded plans that have actually terminated since 2000 – the very riskiest category of plans -- would be able to take advantage of this proposed DRC waiver if they were still in existence, because they, like most major plans, were not subject to the DRC in 2000.[15]

PBGC estimates that the three-year DRC waiver would increase underfunding by $40 billion. It estimates that the proposal would allow cessation of accelerated funding by the corporations that represent close to $60 billion of the estimated total of $80 billion of underfunding in plans sponsored by financially weak employers.[16]

A three-year waiver of the DRC for most underfunded plans would have broad ramifications. While focusing on potential replacements for the 30-year Treasury discount rate – particularly the use of a single corporate bond rate versus a yield curve – Congress has not given close attention to a possible DRC waiver, which could go as far or further to perpetuate or expand underfunding.

It is entirely appropriate to take short-term financial distress into account when considering pension funding policy. However, in order to strike a reasonable balance between competing policy objectives, exceptions need to be studied thoroughly, crafted narrowly to avoid compromising adequate funding in the longer term, and considered in the context of other possible changes designed to ensure adequate long-term pension funding.

A second threshold question is whether other, permanent changes should be made to the defined benefit funding and insurance system. Here too, Congress needs to act soon, although not this year. It is important for the system to transition from temporary funding relief in the short term to an improved, stronger and less volatile funding regime in the medium and longer term, including a broader policy approach to the industry-wide problem of large underfunded legacy costs.

V. Specific Cautions and Considerations

The major statutory reforms of 1986, 1987 and 1994 have left the system in far better condition than would otherwise have been the case. But significant

[14] PBGC October 14, 2003 Testimony, page 10.
[15] Ibid.
[16] Ibid.

unfinished business remains. In large part, it is unfinished because it has proven so difficult to accomplish. Important policy objectives and values are in sharp tension with one another, as discussed. Accordingly, Congress needs to proceed with caution, after thorough analysis, to adjust the funding and related rules in a way that carefully balances the competing considerations. The remainder of this testimony suggests ten specific cautions and considerations.

A. Protect Plan Sponsors from Funding Volatility

It is hard to improve funding in underfunded plans without jeopardizing some plan sponsors' financial stability. Sudden, large funding obligations can push a company over the edge, threaten its access to credit, or prompt management to freeze the plan (i.e., stop further accruals). The current situation – in which short-term relief is needed -- makes it harder still. This is because funding relief generally does not actually reduce the amount the plan sponsor must ultimately pay, as opposed to merely postponing payment. The promised plan benefits are what they are, regardless of the funding rules, and must be paid sooner or later (absent a distress termination).

Accordingly, if short-term relief went too deep or lasted too long, it would put off the day of reckoning, and could cause greater volatility when the temporary relief expired. This could make it harder to implement the necessary longer-term strengthening of pension funding in a gradual manner that would minimize volatility and enable plan sponsors to engage in appropriate advance budgeting.

B. Avoid Penalizing the Plan Sponsors That Are Funding Adequately

Plans of financially healthy companies, even if underfunded, do not present a risk to PBGC or the participating employees so long as the company continues healthy and continues to fund the plan. To attempt to close the premium shortfall by imposing heavy premiums on financially strong plan sponsors would tend to discourage those companies from adopting or continuing to maintain defined benefit plans.

Because the financially stronger defined benefit plan sponsors with adequately funded plans are effectively subsidizing the pension insurance for the weaker ones, there is already a risk, as noted, that the stronger employers will exit the system, leaving a potentially heavier burden to be borne by the remaining premium payers or ultimately by the taxpayers. This risk would be exacerbated to the extent that the subsidy from stronger to weaker employers was increased.

Although PBGC insures benefits in underfunded plans sponsored by insolvent employers, the PBGC premium structure takes into account only the risk of underfunding and not the risk of insolvency (and does not fully take into account even the risk associated with underfunding). Yet PBGC has observed that a large proportion of the sponsors that have shifted their obligations to PBGC in distress terminations had below investment-grade credit ratings for years prior to the termination. This leaves a major element of moral hazard in the insurance program. It is understandable, therefore, that the Administration is exploring whether it would be feasible and practical to better adjust the premiums to the risk by relating the level of premiums – or possibly funding obligations -- to the financial health of the company, as determined by an independent third party such as a rating agency.

C. Improve Transparency and Disclosure of Underfunding

Current law requires plan sponsors to report annually the plan's "current liability" and assets for funding purposes. The Administration has stated in testimony that "workers and retirees deserve a better understanding of the financial condition of their pension plans, that required disclosures should realistically reflect funding of the pension plan on both a current and a termination liability basis, and that better transparency will encourage companies to appropriately fund their plans"[17] (in part on the theory that employees will then be better equipped to press for such funding).

Accordingly, the Administration has proposed to require defined benefit plan sponsors to disclose in their annual summary annual reports to participants the value of plan assets and liabilities on both a current liability basis and a termination liability basis. In general, a plan's current liability means all liabilities to participants accrued to date and determined on a present value basis, on the assumption that the plan is continuing in effect. By contrast, termination liability assumes the plan is terminating, and, according to PBGC studies, is typically higher because it includes costs of termination such as "shutdown benefits" (subsidized early retirement benefits triggered by layoffs or plant shutdowns) and other liabilities that are predicated on the assumption that participants in a terminating plan will tend to retire earlier. This is often the case because, when PBGC takes over a terminating plan, the employer typically has become insolvent or at least has "downsized" significantly.

In addition, the Administration has proposed public disclosure of the special and more timely plan asset and liability information -- the underfunded plan's termination liability, assets, and termination funding ratios -- that sponsors of plans with more than $50 million of underfunding are currently required to share with PBGC on a confidential basis.[18]

Improved transparency and disclosure is desirable. Plan sponsor representatives have raised concerns, however, about the cost of generating

---

[17] Testimony of Ann L. Combs, Assistant Secretary for Employee Benefits Security, U.S. Department of Labor, before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce and the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, July 15, 2003 ("Combs testimony"), page 5.

[18] Generally similar requirements have been proposed in H.R. 3005, the "Pension Security Disclosure Act of 2003," introduced by Rep. Doggett and Ranking Member Miller.

these additional actuarial calculations and about the risk that these disclosures would confuse or unnecessarily alarm participants in plans sponsored by financially strong employers that are able to pay all benefits in the event of plan termination. As noted earlier, Congress should be slow to impose additional costs on sponsors of defined benefit plans that do not present the greatest risks to the PBGC or participants. It is worth considering, therefore, whether such additional disclosure requirements should be limited to sponsors that are financially vulnerable and arguably present some risk of being unable to pay all benefits upon plan termination.

D. Protect Against "Moral Hazard" in Ways That, to the Fullest Extent Possible, Protect Workers' Reasonable Expectations and Allow for the Provision of Continued Benefits

The Administration has put forward several proposals to address the "moral hazard" associated with the current system of pension funding. As stated in the Administration's testimony, a defined benefit plan sponsor "facing financial ruin has the perverse incentive to underfund its … plan while continuing to promise additional pension benefits. The company, its employees, and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan then by other plan sponsors in the form of PBGC guarantees. Financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they must eventually fund them."[19] In addition, a company in economic distress that is strapped for cash might be tempted to respond to pressure for some kind of compensation increase by increasing pension promises rather than providing an immediate pay raise. And employers faced with collective bargaining pressures often have been reluctant to contribute too much to collectively bargained plans out of concern that the unions will demand that any resulting surplus be converted to higher benefits.

To address this longstanding problem, the Administration has proposed to require plan sponsors that have below investment grade credit ratings (or that file for bankruptcy) to immediately and fully fund any additional benefit accruals, lump sum distributions exceeding $5,000, or benefit improvements in plans that are less than 50% funded on a termination basis, by contributing cash or providing security.[20] Thus, continued accruals, lump sum distributions of more than $5,000, and benefit improvements would be prohibited unless fully funded by the employer.

These proposals – particularly a freeze of benefit accruals – should be viewed with caution. First, an empirical question: to what extent are underfunded plans

[19] Combs testimony, pages 6-7.
[20] The Administration's proposal would go significantly beyond current law, which requires sponsors of plans that are less than 60% funded on a "current liability" basis to immediately fund or secure any benefit increase exceeding $10 million.

covering hourly paid workers in fact amended to increase benefits in the expectation that the employer might well be unable to ever fund the additional benefits, and that the PBGC will ultimately assume the obligations?

In addressing this question, it is relevant to recall the differences between two common types of defined benefit pension plans: plans that use a benefit formula based on the employee's pay and so-called "flat benefit" plans, which, in mature industries, account for a large proportion of the actual and potential claims on PBGC's guarantee.

Pay-based or salary-based plans commonly express the employee's pension benefit as a multiple of final pay or career average pay for each year of service for the employer (for example, the annual pension benefit might be 1.5% of the employee's final salary, averaged over the last few years of the employee's career, times years of service). This type of formula – typical in defined benefit plans for salaried workers -- has the effect of increasing the amount of benefits automatically as salary typically rises over time and over the course of an employee's career. This tends to protect salaried employees' pensions from the effects of inflation and to maintain retirement income at a targeted replacement rate relative to the active employee's pay. The plan sponsor projects and funds for the expected increases in pay over the employee's career.

By contrast, flat benefit plans have pension benefit formulas that are not based on salaries or wages – such as a formula for an hourly-paid workforce that expresses the pension benefit as a specified dollar amount per month multiplied by the employee's years of service. Many collectively bargained plans are designed as flat benefit plans in order that the amount of the pension benefit not vary among employees based on differences in pay levels but only based on differences in length of service. Typically, the monthly dollar amounts are increased every three or five years when labor and management renegotiate union contracts because – unlike a pay-based plan formula -- benefit increases do not occur automatically as pay rises.

Typically, the negotiated increases to benefit levels apply not only to future years of service but to past years as well. This accounts for part of the funding problem affecting bargained flat benefit plans: it often is hard for funding to "catch up" with the rising benefit levels because new layers of unfunded benefits attributable to past service are often added before the employer has funded all of the previous layers.

On the other hand, without periodic formula improvements, the fixed hourly benefit would be exposed to inflation and could represent a diminishing portion of the employee's pay over time. Accordingly, many hourly plan benefit improvements can be likened to the automatic salary-driven increases inherent in a salary-based formula, which are designed to meet employees' reasonable expectations regarding the level of post-retirement income replacement. It can be argued, therefore, that hourly plan benefit improvements, to the extent they do not exceed an amount that reasonably serves this regular updating function, should not be subjected to special premiums, guarantee limitations, or funding strictures that might be proposed for other types of benefit improvements in underfunded plans.

Second, new rules in this area need to take into account the fact that PBGC's guarantee of new benefits provided by a plan amendment that has been in effect for less than five years before a plan termination generally is phased in ratably, 20% a year over five years. The five-year phasein provides PBGC with some protection (though far from complete) from claims attributable to benefit improvements that are granted during a corporate "death spiral" before the plan terminates and is taken over by PBGC.

Third, formulation of policy here should take into account the fact that the employees participating in underfunded plans have already given up a portion of their wages in exchange for the promised benefits and generally do not control either the funding of the plan or their employer's financial condition. To what extent should employees suffer the consequences of the employer's failure to fund adequately or the employer's financial weakness? As noted, some would argue that restricting flat benefit plan improvements that essentially reflect wage or cost of living increases would unduly interfere with employees' reasonable expectations regarding their promised retirement benefits. (Others would contend that such restrictions would unduly interfere with collective bargaining as well.) Of course such concerns would be even more applicable to a mandatory freeze of continued accruals at existing benefit levels or a suspension of lump sum payments above $5,000. Requirements to immediately fund or secure benefits can also discourage an employer from increasing benefits if it is willing and able to fund the increase over time but unwilling or unable to secure or fund it immediately.

E. Allow Funding to Take Into Account Expected Single-Sum Benefits

Current IRS rules restrict the ability of a defined benefit plan sponsor to fund based on expected future single-sum distributions even when those would impose larger obligations on the plan than annuity distributions. Instead, employers are required to fund based on the assumption that all employees will choose annuities, even when that assumption is unrealistic. In the interest of more accurate and adequate funding, the rules should allow employers to anticipate funding obligations associated with expected single sums.

F. Beware of Unduly Restricting the Size of Benefit Payments in the Interest of Funding Relief

For an employer, funding is a long-term, aggregate process involving obligations to numerous employees coming due over a period of years. Oftentimes, the employer can manage its risk over time, by adjusting to temporary shortfalls, funding demands, and other changes so that the ebbs and flows can even out in the long run.

For any particular employee, however, the determination of the amount of that individual's pension ordinarily is a one-time, irrevocable event, especially in the case of a single-sum distribution. If, for example, Congress gave employers funding relief in the short term by increasing the funding discount rate, and also applied a higher discount rate to the calculation of single-sum benefits in a way that unduly reduced their value, employees who received those reduced single-sum benefits during such a temporary relief period would suffer irrevocable consequences.

Congress could respond to further developments and experience affecting plan funding by revisiting and readjusting the discount rate and related rules, and employers could adjust accordingly. But an individual who received a reduced pension benefit in the interim would presumably have incurred a permanent reduction relative to the higher value the employee might reasonably have expected, without any opportunity to adjust or recoup the shortfall. Accordingly, a higher discount rate used to provide temporary funding relief should not automatically be applied to determine the lump sum equivalent of an annuity under the plan. As in the past, determining the appropriate discount rates for funding and for single-sum distributions entails two different, albeit related, analyses involving two different sets of considerations.

G. Don't Discourage Defined Benefit Plan Investment in Equities

Defined benefit plans should not be precluded or discouraged from continuing to be reasonably invested in equities. Defined benefit plans in the aggregate reportedly have been more than 60% invested in US and international stocks. It is evident that many plan sponsors have come to view stocks, as well as real estate and other assets that are not fixed income securities, as playing an important role in their investment portfolios. They see investment of a substantial portion of defined benefit plan assets in diversified equities as consistent with the duties ERISA imposes on fiduciaries to invest prudently, in a diversified manner, and to act in the best interests of plan participants.

Of course, as a general matter, stocks traditionally have been expected to generate higher returns, together with greater risk or volatility, than a dedicated portfolio of bonds whose maturities match the durations of the plan's benefit payment obligations. Accordingly, over the long term, many view reasonable investment in equities as consistent with good pension policy – likely to produce higher investment returns that will benefit plan sponsors and, ultimately, participating employees. Any changes to the funding or premium rules that may be intended to take account of the additional risk associated with equities should be crafted with care to avoid penalizing or discouraging defined benefit plan investment in a reasonable portfolio of diversified equities.

H. Be Guided By the Numbers

It is worth bearing in mind the obvious: funding discount rates and other pension funding rules do not directly determine the magnitude of a plan's actual liabilities to pay benefits. Instead, in the first instance the funding rules affect when and how much a company pays into the plan to prefund those liabilities. Accordingly, since funding policy is ultimately a matter of dollars over time, it should be informed by the numbers, rather than focusing on abstract propositions or on doctrinal positions regarding particular elements of funding whose consequences depend on interactions with other elements.

Policymakers in Congress and the Executive Branch need specific data and modeling to help them weigh the likely impact of alternative policies on the funded status of plans. Given particular rules, how many dollars will go into plans and when? The necessary data and analysis are extensive, in part because they must focus on particular industries and even on those specific companies and plans that are large enough to have a material impact on overall policy and on PBGC's financial condition.

Therefore, as Congress approaches the end of the first phase of this policy process – devising a short-term fix – and turns its attention to the next phase – more comprehensive, permanent reform -- it needs the active cooperation of the Executive Branch to give it access to the best available data, analysis and modeling. "Number crunching" is essential to responsible policymaking in the pension funding area. Transparency of analysis – sharing of data and modeling capability by the PBGC, the plan sponsor community, their professional advisers, and others – will be important in the coming months. Of course, the process must carefully protect proprietary and other confidential or sensitive information specific to individual employers, including taxpayer confidential information.

I. Be Cautious of Piecemeal Reforms

The pension funding rules are complex and interrelated. Accordingly, it generally is desirable to develop permanent reforms in a comprehensive manner, as opposed to enacting piecemeal changes to interdependent elements of the system. For example, the valuation of plan liabilities is affected by a set of actuarial assumptions, including a discount rate, mortality and expected retirement assumptions. Each of these represents a simplifying assumption about the amount and timing of a complex and inherently uncertain array of benefit obligations. It generally is preferable to consider possible long-term changes to the discount rate – including any trailing averages or other smoothing or averaging mechanisms and any minimum and maximum rates -- in conjunction with possible changes to the mortality tables, the rates at which plan sponsors are required or permitted to amortize their obligations, the funding levels that trigger accelerated funding and other obligations, and the funding levels above which employers cannot make tax-deductible contributions.

In particular, the crucial objective of controlling volatility in funding is harder to pursue through piecemeal changes that fail to take into account the entire fabric of rules confronting the plan. An effort to smooth in one place, for example, might interact with other rules so as to create sharp discontinuities elsewhere.

J. Clarify the Rules Governing Cash Balance and Other Hybrid Plans

Hybrid plans, such as cash balance pension plans, are plans of one type – defined benefit or defined contribution – that share certain characteristics of the other type. Currently, a major portion of the defined benefit universe takes the form of cash balance or other hybrid plans, as hundreds of sponsors of traditional defined benefit plans have converted those plans to cash balance formats in recent years. However, the precise application of the governing statutes to such hybrid plans has been the subject of uncertainty, litigation and controversy.

Like the regulation of pension funding, the regulation of cash balance plans has potentially far-reaching consequences for the survival of the defined benefit system and for workers' retirement security. The system as a whole would benefit from a resolution of the cash balance controversy that would settle the law governing those plans in a reasonable way. While testifying in June before this Committee's Subcommittee on Employer-Employee Relations, I expressed the view, in response to a question from a Subcommittee Member, that Congress could resolve the cash balance issue in a manner that provides substantial protection to older workers from the adverse effects of a conversion while allowing employers reasonable flexibility to change their plans. At the Subcommittee's request, I submitted additional written testimony illustrating such a legislative approach.[21] If any Member of this Committee is interested, I would be happy to discuss this issue further.

*　　*　　*　　*　　*

Mr. Chairman and Ranking Member Miller, I would be pleased to respond to any questions you and the Members of the Committee might have.

[21] Testimony of J. Mark Iwry before the U.S. House of Representatives, Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003.

Appendix A

More Context Regarding the Private Pension System

In assessing our nation's private pension system, one can readily conclude that the glass is half full and the glass is half empty. The system has been highly successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding $5.6 trillion (excluding IRAs) that has been instrumental in promoting the growth of our economy[22].

Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.[23] However, the benefits earned by many are quite small relative to retirement security needs. Moreover, moderate- and lower-income households are disproportionately represented among the roughly 75 million working Americans who are excluded from the system. They are far less likely to be covered by a retirement plan.[24] When they are covered, they are likely to have disproportionately small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.) Accordingly, the distribution of benefits – retirement benefits and associated tax benefits – by income is tilted upwards.

Yet providing retirement security for moderate- and lower-income workers – in other words, for those who need it most -- should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement affluence – minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.[25] It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

---

[22] Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 6, 2003), tables L.119, 120. This total is as of the end of 2002. It excludes amounts rolled over from plans to IRAs as well as other IRA balances. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Engen, Eric and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (October 2000) ("Engen and Gale 2000").

[23] Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate (Sept. 21, 1999)("Sept. 21, 1999 Testimony").

[24] It has been estimated that over 80% of individuals with earnings over $50,000 a year are covered by an employer retirement plan, while fewer than 40% of individuals with incomes under $25,000 a year are covered by an employer retirement plan. See Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, before the House Committee on Ways and Means, Subcommittee on Oversight, page 6 (March 23, 1999) ("March 23, 1999 Testimony").

[25] March 23, 1999 Testimony, page 3.

Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts, direct to tax-favored accounts current income that would otherwise be saved in nontax-favored vehicles, or offset additional contributions with increased borrowing. But contributions and saving incentives targeted to moderate- and lower-income workers – households that have little if any other savings that could be shifted -- tend to increase net long-term saving.[26] This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

These goals have been articulated by the Department of the Treasury in congressional testimony as follows:

> “First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving….
>
> “Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security….
>
> “Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?”[27]

There are a number of reasons why the system is not doing more to address the needs of moderate- and lower-income workers.

First, tax incentives – the “juice” in our private pension system – are structured in such a way that they prove to be of little if any value to lower-income households. Workers who pay payroll taxes but no income taxes or income taxes at a low marginal rate derive little or no value from an exclusion from income for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings, or from a tax deduction for plan contributions. Roughly three quarters of our population are in the 15%, 10% or zero income tax brackets. (Refundable tax credits – or even currently nonrefundable tax credits

[26] See Engen and Gale (2000).
[27] March 23, 1999 Testimony, pages 3-4.

such as the saver's credit for 401(k) and IRA contributions (as well as voluntary employee contributions to defined benefit plans) under section 25B of the Internal Revenue Code -- would help address this problem.)

Second, obviously, after spending a higher proportion of their income on immediate necessities such as food and shelter, lower-income families often have little if anything left over to save.

Third, lower-income families have less access to financial markets, credit and investments, and tend to have little if any experience with tax-advantaged financial products, investing and private financial institutions.

Fourth, the qualified plan rules permit many moderate- and lower-income workers to be excluded from coverage. The rules provide considerable leeway with respect to proportional coverage of moderate- and lower-income employees, and do not require any coverage of millions of workers whose work arrangements are part-time, based on independent contractor status, contingent or otherwise irregular.

Appendix B

A Personal Note

About a decade ago, the PBGC, together with the Departments of the Treasury, Labor, and Commerce, as well as representatives of OMB, the Council of Economic Advisers, the White House staff and others launched an intensive interagency process to review and reform the funding and pension insurance rules. This process, strongly encouraged by then Congressman Pickle, entailed research, fact-finding, modeling, economic, legal and legislative analysis. Input was solicited from management, organized labor, the financial services industry, other service providers, and other stakeholders in the private pension system, and a serious attempt was made to forge consensus among the various interests.

After months of work in 1993-94 involving several interagency meetings per week under the outstanding leadership of the late Martin Slate, then Executive Director of the PBGC, the Executive Branch made legislative recommendations to reform the funding rules and pension insurance regime. These proposals became the Retirement Protection Act of 1994, enacted as part of the GATT legislation.

Marty Slate saw to it that the PBGC's management processes were significantly improved and that its capacity to intervene in corporate transactions to protect workers' pension security was expanded and actively exercised. Within about two years after enactment of the GATT legislation incorporating the funding and insurance premium reforms, the budgetary deficit that PBGC had run for 21 years was reversed for the first time, and pension funding was improved.

Formerly Director of the Employee Plans Division at the Internal Revenue Service, Marty Slate was, as President Clinton characterized him, "the quintessential public servant." He was driven to achieve excellence and constructive results, and was dedicated to good government and to fairness of process and outcome. Those of us who worked with him in that major effort are the better for it, as is the private pension system.

Now, after an additional decade of experience, it is time to build on that effort and on the 1987 and earlier funding legislation that preceded it. In 1987 and 1994, political pressures and other constraints prevented the accomplishment of all that was needed to reform the system. Meanwhile, the stakes have gotten higher. Over the past decade, the scope of the funding problem has expanded, largely because of the structural industry-wide and demographic developments outlined earlier. Congress and the Executive Branch now confront the challenge of drawing the appropriate lessons from 1994 and the ensuing decade of experience, and completing the unfinished business of reforming the pension funding system.