TESTIMONY OF J. MARK IWRY[1]

BEFORE THE COMMITTEE ON EDUCATION AND THE WORKFORCE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 29, 2004

Chairman Johnson, Ranking Member Andrews, and Members of the Subcommittee, I appreciate the opportunity to appear before you to discuss long-term solutions to reform and strengthen the private defined benefit pension system.[2]

This written testimony is divided into three parts. The first provides brief background on defined benefit plans, pension insurance, the PBGC, and the taxpayers' investment in the private pension system (pages 1-5 and Appendix B). The second part addresses what is perhaps the greatest single source of uncertainty currently affecting the future of the defined benefit plan system: how best to resolve the cash balance pension controversy (pages 5-21 and Appendix C). The third part of this testimony deals with defined benefit pension funding, including recent developments affecting funding and pension insurance (pages 21-25) and the often conflicting public policy objectives that need to be reconciled when formulating policy in this area (pages 25-26). This part then suggests ten specific cautions and considerations to bear in mind when considering longer-term reforms (pages 26-33). As requested on behalf of the Subcommittee, this testimony is limited to issues affecting single-employer defined benefit pension plans, as opposed to multiemployer plans.
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I. Background[3]

A. Context

It is worth pausing for a moment at the outset to consider the objective of strengthening the defined benefit pension system. To be sure, defined benefit

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[1] The witness is a Nonresident Senior Fellow at the Brookings Institution and a lawyer, as detailed in Appendix A. 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. See Appendix A.

[2] Major portions of this written statement are drawn verbatim from the witness's October 29, 2003 testimony before the full Committee, his July 2, 2003 written testimony submitted to this Subcommittee on cash balance pension plan conversions, his September 15, 2003 testimony before the Subcommittee on Financial Management, the Budget, and International Security of the U. S. Senate Committee on Governmental Affairs, and his June 4, 2003 testimony before this Subcommittee.

[3] Further context regarding the private pension system is provided in Appendix B, which is drawn nearly verbatim from my June 4, 2003 testimony before this Subcommittee.

plans have important virtues as retirement programs. While not inherently superior to defined contribution plans – many of the advantages of a DB can be replicated in a different manner through an appropriately designed DC – DB plans (traditional or hybrid) tend to have favorable attributes. These include automatic employer-funded contributions (as opposed to individual salary reduction) and the ability to provide a low-cost annuity that provides lifetime payments.

For public policy purposes, however, it is worth bearing in mind that the formal distinction between defined benefit and defined contribution is not what matters most. It is more useful to examine the specific underlying attributes of a particular plan or plan design (which can be packaged together in different ways) and how they contribute to the desired outcomes. (A cash balance plan, for example, is a defined benefit plan that typically does not provide lifetime guaranteed benefits but rather lump-sum payments; on the other hand, it is funded by employer contributions, so that coverage does not depend on individual employees taking the initiative to participate.)

Accordingly, various types of plans – DBs, DCs, hybrids, 401(k)s – are all worth encouraging as a matter of policy, to the extent that they provide quality coverage that delivers retirement security to those who most need it, i.e., to the extent that they meet the basic public policy objectives of the system. (In a sense, the Social Security system comes close to the classic paradigm of a defined benefit plan that delivers quality coverage.)

Cost-effective retirement security cannot be measured merely by counting the number of plans or even the number of people covered. Instead the desired outcomes need to be measured in a more meaningful way – what amounts of benefits are ultimately delivered, how, and to whom. In a voluntary, tax-subsidized system, plans must occupy that sliver of common ground where they are sufficiently attractive and profitable to employers and other private-sector parties while delivering adequate money's worth to the taxpayers as the return on their $200 billion investment. Maximizing that common ground is often difficult, but rewarding: it helps ensure that our employer plan system – defined benefit plans as well as defined contribution plans and hybrids – continues to be vigorous and to play a central role.

B. 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 31,000 defined benefit plans that are

sponsored by private-sector employers and that cover over 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 34.5 million and about 9.7 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. (As noted, this testimony deals with single employer plans, not multiemployer plans, which were the subject of a recent hearing of this Subcommittee.)

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 in the neighborhood of $200 billion.[4] (Treasury's estimated annual tax expenditure, computed under a different method, is an amount approaching $150 billion.) Of that total, about half 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

[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 2005, Analytical Perspectives ("FY 2005 Budget, Analytical Perspectives"). The budget documents also contain other tax expenditure estimates that are based on alternative methods.

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

II. Cash Balance Pension Conversions: A Legislative Framework for Resolution

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. I believe that Congress can 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 and reasonable certainty regarding the applicable rules.

The following portion of this testimony illustrates a possible legislative framework for resolution of the cash balance pension issue. Of course, no resolution of this highly contentious issue would leave all parties fully satisfied. There is ultimately a sharp tradeoff between protecting older workers from certain changes in plans and preserving employers' flexibility to make changes in a private pension system where they are not required to adopt or continue plans. However, the approach outlined here seeks to illustrate how Congress might find common ground – or at least middle ground – by allowing cash balance plans and conversions, resuming the IRS review and approval process, and giving plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. In a sense, plan sponsors have already pointed the way: corporate 'best practices" in a number of instances have sought to combine reasonable protection for employees with reasonable flexibility for the employer.

The material provided in this statement is illustrative, not prescriptive; it is intended to illustrate that Congress has realistic options for providing cash

[6] FY 2005 Budget, Analytical Perspectives.

balance conversion relief with reasonable employer flexibility, rather than to make specific recommendations.

A. Preliminary Matters

The cash balance pension issue has been the subject of sharply differing views, reflected in proposed legislation, legislative and policy debate, litigation, comments on regulations, academic writing, editorials, etc. In addition, the issues relating to cash balance plans and conversions of traditional defined benefit (DB) pension plans to cash balance plans and other hybrid pension programs are relatively involved.[7]

This statement is intended only to sketch out a "broad-brush" response. It does not rehearse the legal or policy issues presented by cash balance plans and conversions; it does not go into detail regarding the specifics of the approaches outlined here; it certainly does not purport to illustrate how all of the important related issues and major questions in this area might be resolved; and, as noted, it is illustrative or descriptive rather than prescriptive. In the event that the Subcommittee wishes to have further information, I would be glad to respond.

B. Cash Balance Conversion Relief and Employer Flexibility

A central policy concern raised by cash balance plans[8] is whether and how conversions from traditional defined benefit to cash balance plans can be carried out in a manner that sufficiently protects older and long-tenured employees who would otherwise be adversely affected -- without unduly limiting employer flexibility to change their plans and without stifling innovation and creativity in the market and in pension design.[9] In fact, among the significant legal issues that have been raised regarding cash balance plans are whether the plans are inherently age discriminatory and whether conversions are age discriminatory -- particularly whether the plans or conversions violate the age-related proscriptions of section 411(b)(1)(H) of the Internal Revenue Code (IRC) and its counterpart

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[7] Hybrid plans, such as cash balance pension plans are plans of one type – defined benefit (DB) or defined contribution (DC) – that also have characteristics of the other type. In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

The material in this footnote is quoted essentially verbatim from prior testimony of the witness (while serving in the Treasury Department):Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, U. S. Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate, page 4. That testimony contains further discussion of cash balance plans and conversions.

[8] In the interest of avoiding further complexity, this testimony refers to "cash balance plans" rather than attempting to address the issues raised by other forms of hybrid plans such as pension equity plans.

[9] The material in this paragraph is drawn largely from my June 4, 2003 testimony, pages 5-6, 18-19.

provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA).

Plan sponsors undertaking cash balance conversions have adopted a range of provisions intended to provide varying degrees of transition protection to current employees.[10] Some of these protective provisions might be described as corporate "best practices" that are generally similar to the "choice" requirements that would be imposed by H. R. 1677, the Pension Benefits Protection Act, introduced by Congressman Bernie Sanders and this Committee's Ranking Member, Congressman George Miller, and co-sponsored by other Members. The bill requires companies that convert to cash balance plans to allow workers who are either at least 40 years old or have at least 10 years of service the choice to remain in the traditional defined benefit plan.

Other converting employers have provided protection that would not meet the standard established in H.R. 1677, but that some would describe as "good practices" that substantially exceed the requirements that would have been imposed, for example, by the regulations proposed by the Treasury Department in December 2002.[11]

C. Possible Framework for a Legislative Solution

As noted, a possible legislative resolution of the cash balance issue could allow cash balance plans and conversions, resume the IRS review and approval process, and give plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. Thus, at the core of the legislative package would be an essential quid pro quo: a clean bill of health for hybrid plans in exchange for reasonable protection of older/longer serving participants affected by conversions.

It must be recognized that this would break new ground, taking ERISA and the plan qualification rules to a place where they generally have not been before. If Congress is to give effect to a policy rooted in age discrimination concerns raised by conversions to hybrid plans, care must also be taken to minimize collateral damage to employers' willingness to sponsor defined benefit or qualified plans generally. Because of the overall state of the defined benefit system and plan sponsor fears that this type of legislation might portend further legislative restrictions on employers' flexibility to amend plans, some believe such legislation would contribute to widespread defined benefit plan freezes or

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[10] U. S. General Accounting Office, Cash Balance Plans: Implications for Retirement Income, pages 34-36 (2000).

[11] See id. Of course Congress should not view the proposed regulations as a source of potential guidance concerning the appropriate policy balance here. When it developed those regulations, Treasury was operating under a major constraint:: it was required to work within its interpretation of the current statute. As discussed below, Treasury's subsequent legislative proposal goes well beyond the scope of the proposed regulations.

terminations. However, others are concerned that the current uncertainty is likely to be more damaging, and that clear rules are needed for hybrids and conversions.

Minimizing spillover effects of the legislation would involve, among other things, distinguishing conversions to hybrid plans from other types of amendments, in order to make clear that newly-enacted participant protection requirements would apply to conversions but not to other types of amendments (or to plan terminations or freezes). Presumably, for example, the new legislation would not apply to an amendment of a traditional defined benefit plan to move from final to career average pay and/or to eliminate an early retirement subsidy in compliance with current anti-cutback requirements – unless the amendment also involves conversion to hybrid format. Legislators, regulators, or the courts would then need to consider how to deal with step transactions that involve sequential conversions and other amendments.

For these purposes, the legislation would need to define hybrid plans (perhaps in terms that refer, for example, to defined benefit plans that state the accrued benefit as an account balance) and conversions (e.g., amendment of a defined benefit plan that does not, to one that does, state the accrued benefit in terms of an account balance).

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Explicitly or implicitly, the legislation would address hybrid plans in steady state and conversions, at least those that take place after a specified effective date. Explicitly or implicitly, it would also have to deal with past years – steady state and conversions -- or at least be drafted with care to take into account its possible implications for past years and for existing litigation.

By way of illustration, legislation could include the following 12 basic elements:

1. Provide that cash balance plans will not be treated as inherently age discriminatory, i.e., that new or steady-state cash balance plans do not per se violate the age discrimination laws if they would satisfy the defined contribution age discrimination standard of IRC section 411(b)(2).

2. As a condition of treating a conversion as lawful, require the plan to protect a specified class of older and longer-service workers from wearaway of their normal and early retirement benefits.

3. As a further condition, require the plan to give that protected class of older and longer-service participants a reasonable level of additional protection from the adverse effects of the conversion.

4. Prescribe the minimum level of protection in a manner that maximizes employers' flexibility to choose among a specified array of "safe harbor" alternatives for designing their protective arrangements (discussed below).

5. Give employers further flexibility by providing a "safety valve", allowing individual plan sponsors to demonstrate to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors. This could include a "facts and circumstances" demonstration.

6. Give IRS specified additional FTE and budgetary resources to help it address the cash balance backlog, provided Treasury and IRS concur. A conversion that is the subject of such a safety valve application (see #4, above) could not be implemented before IRS had received such additional FTEs and funds or without an IRS determination letter. IRS would be authorized to prescribe reasonable conditions to limit the volume of such case-by-case applications.

7. Direct Treasury to propose, after consultation with EEOC and DOL, regulations implementing the safe harbors and related legislation (replacing the December 2002 proposed regulations) and to resume the IRS determination letter review process for cash balance conversions.

8. Possibly authorize Treasury to publish additional safe harbors that are not less protective of older or longer-service participants than the statutorily described safe harbors and that would not go into effect until after a longer than usual period following their submission to Congress in proposed form.

9. Allow cash balance plans to pay lump-sum distributions of the participant's account balance, subject to possible limitations of interest crediting rates so as not to exceed market rates of return (sometimes referred to as the "whipsaw" issue).

10. To the extent practical, take steps to clarify the application of other related plan qualification provisions to hybrid plans and direct Treasury to fine tune the safe harbors to the extent necessary to coordinate conversion protections for older workers with other plan qualification rules, including the prohibitions on discrimination in favor of highly compensated employees and restrictions on "backloading" of benefits.

11. Provide that the legislation is intended to have no effect on the application or interpretation of the age discrimination laws beyond the limited sphere of hybrid pension plans and conversions.

12. Congress must determine the effective date of the provisions referred to in ## 2-4, above, and whether a reasonable "safe harbor" (involving a lower level of participant protection) should apply to past conversions (including those for which an application for IRS determination letter has been pending) and whether plan sponsors that wish to "top up" their past conversions to meet such a standard should be given specific methods of doing so.

D. Building Blocks for Constructing Conversion Safe Harbors

1. In General

In considering how to design options that employers can use to protect current employees affected by a conversion, it is important to bear in mind that employer flexibility to choose among a menu of alternatives means that, in many instances, the protection will be only as strong as the weakest alternative. In accordance with the character of this discussion as descriptive rather than prescriptive, this testimony is not intended to advocate or recommend a particular approach regarding the degree or specific nature of the conversion protection Congress should require. Determining how much protection to require for current employees from the potential adverse effects of a conversion depends on how the nature and gravity of those effects are viewed and on how employees' interests in protecting their benefits are balanced against plan sponsors' need for flexibility and the potential impact on their willingness to maintain plans.[12]

2. Full Protection of Benefit "Expectations"

[12] The discussion in this part does not address concerns that have been raised to the effect that the basic structure of the cash balance plan formula generally fails to comply with the existing provisions of IRC section 411(b)(1)(H) and similar ADEA and ERISA prohibitions on reduction in the rate of benefit accrual because of the attainment of any age. To the extent that concerns such as these are viewed as more in the nature of legal concerns under the current statutory provisions than policy concerns, they could be addressed as part of a legislative package, such as that outlined here, that would protect older workers from the adverse effects of cash balance conversions. At the same time, such concerns can also reflect an underlying policy concern about the effects of cash balance plans and of legislation that might encourage them. This testimony does not attempt to address the debate regarding the policy merits and drawbacks of hybrid plans.

According to one view, the law should protect older workers' expectations of future higher benefits under a traditional DB plan from the effects of a conversion – as some employers have done – because older workers affected by the conversion have given up current wages (whether implicitly or explicitly) in exchange for a traditional pension formula that provides only modest benefits in the employee's earlier years on the understanding that longer-serving employees will be more richly rewarded late in their career. In addition, under a related view, conversions often discriminate against older workers, treating them less favorably than younger employees. These concerns might suggest requiring older or longer-service employees to be grandfathered in the old formula benefit, giving them the greater of the old and new formula benefit, or giving them a choice between the two formulas at retirement.[13] See, for example, H.R. 1677.

Some employers have extended such grandfathering, "greater of" treatment, or choice to a specified class of individuals who participated in the traditional DB plan at conversion (e.g., those who have reached a certain age and/or have completed a certain period of service as of the conversion). Variations of this view – reflected in various other corporate practices and in Treasury's legislative proposal, discussed below -- would require such protection to last only for a limited period of years.

Under these approaches, it is assumed that where the conversion is intended to reduce pension costs for the plan sponsor or to spread the benefits of the DB plan more broadly among the work force, the temporary transition relief for current employees will not prevent the sponsor from realizing those benefits in the long run, as the number of nongrandfathered employees grows while the number of grandfathered employees diminishes.

3. Preventing the Worst of Both Worlds

A different view is driven more by a recognition of the employer's ability to freeze or terminate a DB plan, even a traditional one with a "backloaded" pattern of benefits, and by a concern about the impact on the private employer-sponsored pension system of beginning to require qualified plan sponsors to protect employee expectations of future benefit accruals. For some, however, this concern is tempered by a recognition that a conversion can result in a smaller total benefit for an employee than if he or she had been covered by the cash balance plan for the employee's entire career. This can occur because, during

[13] Some contend that employee choice regarding such technical matters is less appropriate than grandfathering employees in the old formula to the extent it would provide a greater benefit at retirement. Under this view, permitting employees a choice at retirement amounts to little more than offering a choice between more money and less – an exercise that is either wasted motion or, in a few cases, unnecessarily risky. And offering employees a choice at the time of conversion presents an undue risk of unwise or uninformed choices, which can ultimately result in remorse and litigation to the detriment of both employees and employers. In view of the risk of eventual litigation, the concern has been expressed that choice at conversion puts excessive pressure on the accuracy, comprehensiveness, and usefulness of the plan sponsor's disclosures and any related assistance to employees. Choice also raises issues relating to the handling of plan amendments that take effect between conversion and retirement.

the early years of one's career, the traditional DB might provide smaller benefits than the cash balance plan. (This is sometimes referred to as the "bow tie" effect, reflecting of the shape of the graph depicting it.)

Thus, some would hold that even if it were impractical for the system to require converting employers to guarantee their workers the best of both worlds (the greater of the old and new formulas or a choice between them), it should at least require employers to protect their employees from the worst of both worlds. One method of preventing the "bow tie" effect is to establish an opening account balance equal to the present value of a hypothetically "reconstructed" cash balance benefit. This would be the benefit the employee would have earned before the conversion date had the cash balance formula covered the employee since he or she began work with the employer (assuming that amount exceeds the present value of the employee's actual pre-conversion accrued benefit under the traditional DB plan). Alternatively, if the "sum-of" (A+B) method (discussed below) is used, and if the present value of the A piece (the frozen old-formula benefit) is less than the hypothetically reconstructed preconversion cash balance benefit, then the present value of the A element might be increased to equal that reconstructed benefit.

4. Preventing Wearaway

"Greater-of" Approach. A related adverse effect of a conversion on employees is the extended suspension of new benefit accruals that can occur after a conversion when employees are promised the greater of an old-formula benefit that is frozen (because additional service is not earning employees additional benefits under that formula) and a new-formula benefit that is less generous but that does continue to grow with additional service. This so-called "wearaway" of the frozen old-formula benefit – whereby no new net benefits are being earned so long as the frozen old-formula benefit continues to exceed the growing new-formula benefit – can apply to the normal retirement benefit (typically the benefit payable at age 65) and to the early retirement benefit. In many cases, where the early retirement benefit is "subsidized" and hence is actuarially more valuable than the normal retirement benefit, the wearaway of the early retirement benefit will be potentially more costly to the employee than the wearaway of the normal retirement benefit.

Some would advocate requiring protection only to the extent necessary to prevent or to simply mitigate the wearaway – of either the normal and early retirement benefits or only the normal retirement benefit. (The December 2002 proposed Treasury regulations would require converting plan sponsors to take steps to mitigate the wearaway of the normal retirement benefit, but the Treasury's later legislative proposal would prohibit wearaway of the early retirement benefit as well.)

<u>"Sum-of" or "A+B" Approach.</u> This approach would formulate protections based generally on a policy that employers should continue to be free in the future to stop one plan formula and start another, but without offsetting the old benefits against the new – at least not in a way that particularly disadvantages older workers. Thus, the employer could be required to mimic the result that would obtain if it froze the traditional DB plan and adopted a new cash balance plan that provided benefits wholly unrelated to the old frozen plan benefits.

This would suggest a 'sum-of" or "A+B" approach whereby employees' normal and early retirement benefits after the conversion are equal to the sum of the normal or early retirement benefits they earned before the conversion under the old plan formula (the "A" element) and the cash balance benefits they earn after the conversion (the "B" element). (This "sum-of" approach is contrasted with the "greater-of" approach described above, which promises employees the greater of an old-formula frozen benefit and a growing new-formula cash balance benefit.)

<u>Recognizing Post-Conversion Compensation Increases</u>. A variation would require the employer to increase the "A" element – the benefit earned under the old formula before conversion – to reflect post-conversion increases in compensation (though not post-conversion service). The rationale would be that, even if the employee is not grandfathered in the entire old formula such that it would continue to apply to service after the conversion, the final average pay feature of the old formula was a particularly key element of the employee's expectations that should be honored after the conversion. In addition, essentially indexing the pre-conversion benefit for inflation in this manner can help address the concern of those who believe that merely preventing post-conversion wearaway does too little to offset the harm to older employees.

<u>Immediate Vesting</u>. Another possible element would be to require full and immediate vesting of benefits (to the extent funded) upon the conversion. The rationale for this would be that the conversion, if likened to a freeze of one plan and establishment of another, has an effect similar to a partial termination of a plan that would require immediate vesting.[14]

<u>Establishing Opening Account Balance to Prevent Wearaway of Normal Benefit</u>. A variation on the "sum-of" approach would allow the employer, as an alternative, to establish an opening account balance under the cash balance formula that includes the full present value of the normal retirement benefit the employee had earned under the traditional plan formula before the conversion, and that grows as the employee earns cash balance pay and interest credits. Congress could require the present value to be calculated using actuarial assumptions that include the statutorily prescribed interest rate for determining present values of pension benefits. The advantage of this alternative to the

[14] Some have argued that conversions should be treated as plan terminations, triggering not only immediate vesting but also annuitization and excise and income tax on any surplus assets.

"sum-of" is presentational simplicity: it presents the full normal retirement benefit, pre- and post-conversion, in a single format, as an account balance.

A major drawback, however, is that the opening account balance approach does not readily lend itself to preventing wearaway of early retirement benefits. (It also does not readily lend itself to recognizing the effect of post-conversion compensation increases on the traditional old-formula benefit.) Early retirement benefits under a traditional DB plan can be particularly valuable because they often are "subsidized" relative to the normal retirement benefit (i.e, the monthly or annual payment under the early retirement annuity is not reduced – or not reduced sufficiently -- to reflect the fact that it begins earlier and therefore is expected to make more payments than the age-65 annuity). Consequently, the opening account balance method needs to be supplemented by a contingent early retirement subsidy (the "pop-up" benefit described below).

"Pop-Up" Early Retirement Subsidy. An early retirement subsidy is a contingent benefit. Its value depends on whether and when the employee retires. An employee does not realize any early retirement subsidy if he or she terminates employment either before becoming eligible for it or after reaching normal retirement age. Consequently, the value of the subsidy is not readily captured in a post-conversion opening account balance. Attempts to do so, depending on how they are designed, tend to result in age discrimination, partial loss of benefits, and windfalls.

However, early retirement subsidies can be preserved on a contingent, "springing" basis. The plan keeps track of the subsidy under the old formula and prevents wearaway of the subsidy by adding it to the employee's total retirement benefit (under the old and new formulas) if and when the employee retires early and qualifies for it. This "pop-up" protection can be quite important to employees, although employers note that it comes at a cost in terms of presentational simplicity. It can also be combined with the use of an opening account balance that reflects the present value of the normal retirement benefit earned before the conversion.

5. Greater of "Sum-of" and "Greater-of"

Another variation would provide a normal retirement benefit equal to the greater of the benefit produced by the "sum-of" A+B method and the "greater-of" (opening account balance) method. As noted,

- the "sum-of" method provides a total benefit equal to the sum of the frozen old formula pre-conversion benefit in the form expressed under the traditional plan ("A") and the new formula account balance resulting from annual post-conversion cash balance pay and interest credits ("B");

- the "greater-of" method provides a total benefit equal to the greater of the old formula frozen benefit and the new formula account balance, which in

turn consists of an opening account balance equal to the present value of the pre-conversion benefit plus annual post-conversion cash balance pay and interest credits.

This approach would prevent wearaway without the associated risk, under some circumstances, that the final benefit will be less than it would be under a "greater-of" approach.

6. "Straight-lining": Preventing Reduction of the Pre-Conversion Accrual Rate

Another view would stop short of requiring protection of employees' expectations of steadily increasing accrual rates under the traditional defined benefit plan, but would interpret the section 411(b)(1)(H) prohibition on reducing the rate of benefit accrual because of age as requiring a comparison of older and younger employees' rates of benefit accrual before and after the conversion. Instead of comparing a conversion to a freeze of one plan and fresh-start adoption of another, this approach would take the view that because the conversion is a plan amendment and the plan retains its defined benefit character, the conversion should be analyzed as a plan amendment under IRC section 411(b)(1)(H) to determine whether it reduces the rate of benefit accrual because of age.

To permit an "apples to apples" comparison for this purpose, one could take the present value of the traditional DB plan's pre-conversion rate of accrual and express it as an equivalent allocation rate (i.e., an equivalent DC plan contribution) or cash balance pay credit.

- For example, a conversion might provide a 5%-of-pay hypothetical cash balance contribution or pay credit to all employees, including an older employee who had an accrual rate under the traditional DB plan equivalent to a 12%-of-pay contribution and a younger employee who had an accrual rate under the traditional plan equivalent to a 4%-of-pay contribution.

Under one view, the conversion would have impermissibly reduced the rate of benefit accrual on account of age. Under such an interpretation, preventing age discrimination would not require grandfathering an older employee in his or her traditional DB benefit formula, including expected future increases in the rate of benefit accrual, but only in a pay credit equivalent to the employee's pre-conversion rate of benefit accrual. Literal adoption of such an approach would give rise to a host of issues, such as the practical complexity of maintaining many different age-sensitive pay credit rates and coordination with qualified plan standards designed to prevent discrimination in favor of highly paid employees. One alternative, however, would be to view this concept not as an application of current law but rather as an underlying theory that might serve as a basis for

designing a safe harbor, available for future conversions, that would involve age- or service-weighted pay credits (as described in the following section).

7. Age- or Service-Weighted Pay Credits or Opening Balances

A practice not uncommon among converting employers has been to provide for a tiered pay credit rate under the cash balance plan – a higher pay credit percentage for older (or longer service) employees than for younger (or shorter service) employees – though not necessarily as high as would be needed to equal the older worker's pre-conversion rate of accrual (see 6, above).

Congress could, if it wished, borrow a leaf from these employers. A conversion could be treated as not age discriminatory if older employees receive sufficiently high and durable cash balance pay credits – defined by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Like other ameliorative measures, such an approach would need to be carefully crafted to avoid doing violence to age discrimination law generally. It also would need to be coordinated with qualified plan nondiscrimination policy and standards.

Additional amounts credited to older employees' opening account balances might be designated as another permissible means of offsetting the adverse effects of the conversion, if meaningful equivalencies can be determined. It is difficult, however, to preserve the benefits of an early retirement subsidy solely through higher pay credits or an additional opening account balance, as opposed to an additional benefit that becomes payable if and when a participant becomes eligible for the early retirement subsidy after retiring (the "pop-up" approach).

E. Conversion Safe Harbors

As noted earlier, Congress could prescribe minimum standards for protecting employees from the adverse effects of cash balance conversions by giving employers flexibility to choose among a specified array of "safe harbor" alternatives for designing protective arrangements.

In addition to defining safe harbors (which could be fleshed out through regulations once they were sufficiently described in the statute), Congress would need to determine how non-safe-harbor conversions would be treated. For example, one possible approach would be to provide that a conversion that does not satisfy any safe harbor is vulnerable to challenge as age discriminatory (i.e., it reduces the rate of benefit accrual on account of age in violation of the statutory provisions) and is not entitled to an IRS determination letter covering the age discrimination issue, unless the specific facts demonstrate otherwise. Another approach would be to provide that such a conversion is subject to a rebuttable presumption that it reduces the rate of benefit accrual because of age.

As noted, this testimony is not intended to suggest where Congress should set the bar, i.e., it does not advocate or recommend a particular approach regarding the amount or type of conversion protection Congress should require.

Conversion safe harbors could be constructed from the methods or "building blocks" described above. By way of illustration, possible safe harbors might include provisions along the lines of the following:

1. Full Protection of "Expected" Benefits. One safe harbor could require protection of older or longer-service employees' old-formula benefit expectations, including expectations regarding future increases in the rate of benefit accrual. This protection could take the form of being (a) grandfathered in the old formula benefit, (b) given the greater of the old and new formula benefit at retirement, or (c) given a choice between the two formulas at retirement. See D.2, above.

- In addition to limiting the required protection to a particular class of employees by age and service, Congress could, if it thought it appropriate, limit the duration of the required protection.

2. Preservation of Pre-Conversion Rate of Accrual. A second safe harbor might treat a conversion as not reducing the rate of benefit accrual because of age if the plan provided age-weighted (or age- and service-weighted) pay credits based on the pay credit equivalents of employees' pre-conversion rates of benefit accrual. See D.7, above.

- If Congress thought it appropriate, it could set the bar for age-weighted pay credits somewhat lower than – but taking into account -- the level required to make employees whole relative to their pre-conversion accrual rates. The legislation could, for example, define the level of credits required for older employees by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Congress might also allow other types of credits – such as one-time transition credits added to the opening account balance -- to substitute for some or all of the higher pay credits, although the determination of rough equivalencies would not be straightforward. See D.7, above.

3. "Sum-of" (A+B) Plus Early Retirement Subsidy Pop-Up and Compensation Updates to Old-Formula Benefit. A third safe harbor might be constructed by building on the anti-wearaway protections described in D.4, above. Just as Congress, if it decided to seek a middle ground between competing interests, would have to determine how much to limit or subtract from the basic structure of the first two safe harbors (full grandfathering), it would similarly have to decide how much to build up or add to the basic structure of this third safe harbor (the "sum-of" approach to preventing wearaway).

Often, the two aspects of the traditional DB benefit formula that contribute most to the “backloaded” character of the plan are early retirement subsidies and the final average pay feature. If it wished to, Congress could partially offset the loss of these features by, for example, designing a safe harbor that begins with the “sum-of” (A+B) method and adds both an early retirement subsidy pop-up and recognition of post-conversion compensation increases in determining the value of the “A” element (the frozen old-formula benefit). See D.4, above.

4. Enhanced Opening Account Balance Plus Early Retirement Subsidy Pop-Up. As an alternative to the “sum-of” approach, which starts with a zero account balance after the conversion, another safe harbor could permit use of the opening account balance method outlined in D.4, above. Under that method, the cash balance account begins by including the full present value (determined using the statutory interest rate) of the employee’s pre-conversion normal retirement benefit, and grows as the employee earns cash balance pay and interest credits.

As in the previous safe harbor, early retirement subsidies under the traditional plan would be preserved via an early retirement subsidy pop-up. However, since this single account balance (opening account balance) method does not readily accommodate recognition of post-conversion compensation increases in determining benefits, the employer might be required to increase the opening account balance by a specified percentage as a rough-justice substitute.

5. Safety Valve Facts and Circumstances Determination. As an alternative to using a safe harbor method, employers might be given further flexibility through a “safety valve” procedure allowing individual employers to make a “facts and circumstances” demonstration to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors or that, in any event, their conversion does not reduce the rate of benefit accrual because of age in violation of IRC section 411(b)(1)(H).

Any such safety valve option would likely impose heavy demands on IRS resources. Processing such an application would be a labor-intensive procedure requiring highly trained technical personnel, who are in short supply. Accordingly, access to such a determination would need to be, in effect, rationed. This could be done by appropriately limiting the eligibility conditions. In addition, a natural rationing process might occur as plan sponsors seeking such special determinations instead of complying with one of the safe harbors would be forced to wait in the queue and probably endure substantial delays. Of course such rationing would be justifiable only if the safe harbors were reasonable.

*   *   *   *   *

As an additional cross-cutting requirement, converting employers, regardless of which safe harbor they are relying on, might be required to protect employees

from the “worst of both worlds” situation described in D.3, above, using the “reconstructed account balance” described there or an alternative method.

* * * * *

F. Treasury’s Legislative Proposal

In response to a congressional directive, the Treasury Department suspended its cash balance regulations project and, in February 2004, issued a legislative proposal regarding cash balance conversions. Substantial elements of the Treasury proposal (summarized in Appendix C to this testimony) are similar to elements outlined above and in my July 1, 2003 written statement submitted to the Subcommittee.

In my view, the Treasury proposal represents a serious and constructive first step toward a solution. Congress should carefully consider a number of the elements in Treasury’s proposal when it crafts legislation. However, the Treasury proposal as a whole should not be viewed as meeting the requirements of an adequate solution, for reasons summarized in Appendix C.

G. Dealing With Past Conversions

As noted, the process of crafting such legislation also requires dealing – explicitly or implicitly – with past years, including conversions that occurred in the past. Any bill would need to be drafted with care to take into account its possible implications for past years and for existing litigation. A number of alternative approaches are possible, including --

1. Statutory silence regarding past conversions with no inference language in the legislative history.

2. Required protections for past conversions (significantly lower than those required for future conversions) as a condition of obtaining comfort regarding past steady state hybrids or a safe harbor for past conversions that does not impose an explicit requirement.

3. Some kind of process for obtaining comfort and resolving disputes regarding past conversions.

Plan sponsors that undertook conversions in the past would ideally wish for an explicit clean bill of health for past conversions. But if this is not feasible, then, according to one point of view, legislation should establish a prospective effective date for conversion requirements and “no inference” language regarding past conversions.[15] According to this view, plan sponsors are better off without any

[15] Many argue that, when converting in the past, employers had no way of knowing that any particular standard would apply; that they read signals from the government (e.g., section 401(a)(4) regulation safe

statutory provisions seeking to provide “comfort” for past years: a safe harbor for past conversions arguably invites plaintiffs to challenge all conversions failing to meet the safe harbor. The variety of transition provisions in past conversions means many might not satisfy any single or simple safe harbor.

Under a second and different view, at least some cash balance plan sponsors would welcome the certainty of being able to obtain comfort that their past conversions will not be challenged in court and that their hybrid plan will not be treated as age discriminatory in its steady state for past as well as future years. Under this approach, a statute that prescribes specific requirements for future conversions but provides only a reasonable and significantly lower safe harbor standard for past conversions would not mean that past conversions failing to meet the safe harbor are necessarily age discriminatory or otherwise violate the plan qualification requirements. (The safe harbor would prescribe one method -- but not the only method[16] -- of demonstrating that the conversion was not age discriminatory.) But such legislation would give comfort to employers whose past conversions met the safe harbor and would give a choice to employers that want protection to top up and meet the safe harbor retroactively

Finally, others would argue that, just as the price of an explicit statutory blessing of future steady state hybrid plans might be adequate protection of older participants in future conversions, the price of any statutory protection of employers from litigation over steady state hybrids in past years should be at least some protection of older workers in past conversions. Plan sponsors whose past conversions failed to meet this lower bar (presumably in the form of a safe harbor) would be able to “top up” after the fact, at least with respect to affected older employees who are still active, and would have guidance on how much top up is necessary on a safe harbor basis. According to this view, the employees who are most aggrieved are those adversely affected by the many past conversions – at least those that did not provide adequate transition relief – and because many of these employees have yet to retire, their benefits have not yet been definitively calculated.

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harbor provision and preamble sentence, Notice 96-8 and, arguably, section 204(h) notice advance disclosure legislation) stating, suggesting or implying, as the case may be, that steady state cash balance plans were not age discriminatory, and numerous cash balance plans received IRS determination letters following conversion. Others respond that cash balance plans by their nature violated the literal terms of the three statutes; that conversions that failed to protect older participants were age discriminatory, and that at least some employers and their advisers were aware, while others arguably should have been aware, of this possibility.

[16] A possible alternative approach might: allow controversies over past conversions to be resolved through a process established by legislation. The process might involve alternative dispute resolution without a government role or, alternatively, it might be a governmental process such as the opportunity to apply for an IRS determination that a past conversion (with or without top-up) satisfied a standard designed to prohibit age discrimination.

A number of the potential arrangements described here can be viewed as means of giving employees "half a loaf" – although the exact fraction that is or should be provided is the subject of vigorous debate. If Congress wished to find middle ground on this issue that strikes a balance between the legitimate competing interests, these are tools it can use (in addition to other techniques not described here). As noted, however, it is not the purpose of this discussion to suggest where Congress should strike any such balance along the spectrum of possible requirements from fuller protection (as in H.R. 1677) to far more limited protection.

In addition, this discussion does not attempt to be comprehensive. It does not address many of the other issues implicated by or relevant to a legislative approach to conversions (other rules governing cash balance plans, application of a legislative approach to other hybrid plans, coordination with rules prohibiting discrimination in favor of highly compensated employees and restricting backloading, sanctions, financial accounting issues, etc.[17]).

* * * * *

III. Reforms Relating to Pension Funding and Pension Insurance

A. Recent Developments

1. Increased Underfunding and PBGC Deficit

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 by the end of FY 2002 and $11.2 billion by the end of FY 2003. In FY 2003, the PBGC paid benefits (and administrative costs) worth $2.5 billion (nearly $1 billion more than those paid in FY 2002), while collecting nearly $1 billion in premiums. Overall, PBGC's assets of $34 billion indicate that it has the wherewithal to continue meeting its obligations for some years to come.

PBGC's financial condition could alternatively be expressed in percent funded terms, taking PBGC's assets as a percentage of its liabilities, in a manner somewhat analogous to the ratios used to assess the funding status of the pension plans PBGC guarantees. At the end of FY 2003, the ratio of PBGC's

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[17] Some have argued, for example, that future legislation should not permit conversions to cash balance plans that are "integrated" with Social Security (i.e., that use a formula that takes advantage of "permitted disparity" referred to in IRC section 401(l) to provide a higher pay credit for compensation above than for compensation below a specified level) on the theory that this plan design is inconsistent with the rationale for hybrid plans to the effect that they are easy for participants to understand.

reported $34 billion in assets to its reported $45.3 billion in liabilities was 75%. This represented a decline from 87.6% at the end of FY 2002, although the PBGC's net loss has diminished in the past year, from $11.4 billion in FY 2002 to $ 7.6 billion in FY 2003. (Losses from plan terminations declined by about $4 billion between FY 2002 and FY 2003.)[18] However, PBGC's funded percentage, like any assessment of its financial condition, is highly sensitive to the judgments made as to the probability of future liabilities and assets, including PBGC's estimates of the total assets it can expect to recover if and when "probable" future claims materialize.

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 -- have contributed dramatically to the underfunding problem. Of the $7.6 net loss for FY 2003, a large portion was caused by pension plan terminations (actual and probable) and another large (though slightly smaller) portion was attributable to increased liabilities due to lower interest rates.

According to PBGC estimates in 2003, its losses might ultimately include an additional $83 to $85 billion of unfunded vested benefits that the agency would be required to take over if certain plans maintained by financially weak employers were to terminate.[19] It is hard to quantify such exposure with much confidence because the results could vary widely depending on the financial condition of a small number of companies in a few industries. However, based on last year's estimates, the General Accounting Office in 2003 placed PBGC's single-employer insurance program on its high-risk list of federal agencies with significant vulnerabilities.

To help put the amounts into perspective, the total amount of defined benefit pension benefits PBGC insures is approximately $1.5 trillion, and PBGC has estimated that total underfunding in the single-employer defined benefit system amounts to more than $350 billion. (Before 2001, the previous high water mark in underfunding had been little more than one fourth of that amount, in 1993.) Of the $350 billion, the $83-$85 billion figure cited earlier represents estimated underfunding in plans sponsored by financially troubled companies (where PBGC estimates that plan termination is "reasonably possible"). However, it should be emphasized that this is a "soft" estimate, which, like PBGC's financial condition generally, is quite uncertain because, as noted, it is highly sensitive to the risk of a few large bankruptcies.

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

[18] PBGC 2003 Annual Report.
[19] PBGC Annual Report for 2003, page 19.

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 a large portion 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.[20] For example, in 2002, PBGC involuntarily terminated a plan of Bethlehem Steel Corporation that had total underfunding of about $4.3 billion. (PBGC indicates that, in the plan sponsor's last filing before termination, the sponsor reported that the plan was 84% funded on a "current liability" basis, but upon termination the plan proved to be only 45% funded on a "termination basis.")

2. Recently Enacted Short-Term Legislative Solution

On April 10, 2004, the President signed into law H.R. 3108 (originally sponsored by Chairman Boehner and cosponsored by Subcommittee Chairman Johnson and Committee Ranking Member Miller), the Pension Funding Equity Act. This legislation provided short-term funding relief to the sponsors of defined benefit plans by replacing the 30-year Treasury bond discount rate for determining pension liabilities with a higher corporate bond rate, thus reducing the present value of liabilities. The new rate applies through 2005.

The Act also reduces the special accelerated funding requirements (the "deficit reduction contribution" or "DRC") imposed on significantly underfunded plans as a result of the 1987 and 1994 pension funding reforms -- but the Act limits this relief to airline and steel company plans. The legislation reduces the DRC for those plans by 80 percent for the next two years. The statute gives special funding relief to certain multiemployer plans as well.

3. Other Fundamental Trends

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

[20] Most of the financial data in this testimony regarding PBGC and its exposure are from PBGC's 2003 annual report . Some of the data 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.

worker spent 11.5 years in retirement in 1950, compared to 18.1 years today.[21] 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 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 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

[21] See, e.g., PBGC Annual Report for 2003, page 6.

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.[22] 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.

B. 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,

[22] 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 Subcommittee, June 4, 2003, as well as the testimony of other witnesses presented at a hearing of the Subcommittee on that date.

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.

- 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".

Balancing these objectives is exceedingly difficult. However, the system needs to transition from temporary funding relief 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.

C. Specific Cautions and Considerations

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

1. Avoid Penalizing 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.[23]

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[23] 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

2. Assist Plan Sponsors to Protect Themselves from Funding Volatility and Reconsider De Novo the Appropriate Permanent Funding Discount Rate

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 recent circumstances that necessitated the short-term funding relief Congress has just enacted have made the task 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 goes too deep or lasts too long, it puts off the day of reckoning, and can cause greater volatility when it expires. This can make it harder to strengthen long-term pension funding in a gradual manner that minimizes volatility and enables plan sponsors to engage in appropriate advance budgeting.

Congress should not view the recently enacted two-year funding interest rate relief as having permanently or presumptively laid to rest the issue of the appropriate long-term funding discount rate. Congress should now take up that issue de novo, balancing all of the considerations that are relevant to a long-term determination, including the need for adequate long-term funding to protect participants' benefits and the potential effects on employer willingness to sponsor defined benefit plans.

3. 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"[24]

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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. The Administration has indicated that it is therefore 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. Any such approach would raise significant concerns for plan sponsors.

[24] 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.

(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.[25]

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

4. 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 Administration 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

[25] 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.

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."[26] 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.[27] 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 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

[26] Combs testimony, pages 6-7.
[27] 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.

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.

5. Allow Plan Sponsors to Fund Taking 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.

6. Beware of Unduly Restricting the Size of Benefit Payments (Including Single Sums) in the Name 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 permanent funding relief 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, the discount rate prescribed for funding 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.

7. Arrange for Congressional Access to Relevant Data and to Modeling

It is worth recalling 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 considers comprehensive, permanent reform, it needs the active cooperation of the Executive Branch to give it access to the best available data, analysis and modeling. Transparency of analysis – sharing of data and modeling capability by the PBGC, the plan sponsor community, their professional advisers, and others – is a necessary condition of responsible policymaking with respect to pension funding. Of course, the process must carefully protect proprietary and other confidential or sensitive information specific to individual employers, including taxpayer confidential information.

8. Beware of Measures That Could Jeopardize Long-Term Fiscal Responsibility

Legislative measures that would enhance retirement security may entail significant revenue costs. If paid for through appropriate offsets, such legislation can of course represent an entirely justifiable expenditure of tax dollars. However, particularly in view of the current federal budget deficit, certain kinds of proposals involving revenue costs should be viewed with particular skepticism. These are proposals to change the expected tax treatment of current pension accumulations by exempting a portion of

those accumulations from taxation in the name of encouraging annuitization or for other reasons.

While encouraging lifetime guaranteed benefits is important -- and in fact is one of the main reasons for supporting the defined benefit system -- proposals to exempt from taxation otherwise taxable distributions of current pension balances present serious issues of fiscal responsibility. Trillions of dollars of benefits have accumulated with the aid of tax-favored contributions and tax-deferred earnings, with the understanding that they would be taxed upon distribution. In the long term, responsible federal budget policy is dependent on income tax revenues from these benefits accumulated in defined benefit and defined contribution plans. The "slippery slope" potential of measures that would exempt a portion of these accumulations from tax should not be underestimated.

9. Be Wary 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.

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

The regulation of cash balance and other hybrid plans has important consequences for the future of the defined benefit system and for workers' retirement security. As discussed at length earlier in this testimony, I believe that Congress can and should resolve the cash balance issue in a manner that provides substantial protection to older workers affected by conversions while allowing employers reasonable flexibility to change their plans and reasonable certainty regarding the applicable rules.

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

Appendix A

Biographical Information

The following biographical information is provided at the Subcommittee's request:

J. Mark Iwry served from 1995 to 2001 as the Benefits Tax Counsel at the U.S. Department of the Treasury. During that time, he was the principal Executive Branch official responsible for tax policy and regulation relating to the Nation's tax-qualified pension and 401(k) plans and other employee benefits. He is currently a nonresident Senior Fellow at the Brookings Institution and practices law with the firm of Sullivan & Cromwell, specializing in pensions, executive compensation, health care and other employee benefits. Mr. Iwry's testimony before this subcommittee reflects only his individual views. The views expressed in his testimony are his personal views only. Those views should not be attributed to the staff, officers, or trustees of the Brookings Institution or to Sullivan & Cromwell or any client of that firm.

Mr. Iwry has testified before various congressional committees – both on behalf of the Executive Branch and the Treasury Department and, since leaving government, as an independent expert – and has previously been a partner in the law firm of Covington & Burling, has chaired the Employee Benefits Committee of the D.C. Bar, has co-authored a volume on 401(k) plans, and has spoken before more than 200 professional, industry and other groups in the US and abroad.

While in government, he was widely recognized for his work with the business, financial, professional and nonprofit communities to expand coverage while simplifying and rationalizing pension and benefits law. In 2001 he received the Secretary of the Treasury's Exceptional Service Award "[i]n recognition of his outstanding leadership and accomplishments ….Widely respected as Treasury's benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests… His technical acumen and leadership have garnered praise from colleagues within Treasury, the IRS, the Congress, and the employee benefits community at large."

Mr. Iwry played a central role in developing the Saver's Credit to expand 401(k) and IRA coverage of moderate- and lower-income workers (claimed last year on over 3 million tax returns) and the "SIMPLE" 401(k)-type plan for small businesses (now covering an estimated 2 million workers). He also has initiated or orchestrated numerous other significant improvements and simplifications of the Nation's pension system and benefits law and regulation, such as approval and expansion of automatic enrollment in 401(k) and 403(b) plans, the automatic rollover IRA to curtail pension leakage, repeal of the complex section 415(e) combined limit on pension benefits, simplification and liberalization of IRA and employer plan minimum distribution rules, new incentives for immediate 401(k) participation, and development of workable rules for pension portability, anticutback relief, 401(k) safe harbor plans, same desk rule and other benefits in corporate transactions, electronic plan administration, new comparability, COBRA, health care portability, Social Security taxation of deferred compensation, and cafeteria/flexible benefit plans.

Mr. Iwry received a special award from the IRS (Office of Chief Counsel) in 2001 "[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation's tax system." He has regularly advised Members of Congress and congressional staff on both sides of the aisle, and his views are frequently reported in the Wall Street Journal, New York Times, Washington Post, and other major media and trade press.

Mr. Iwry is an honors graduate of Harvard College and Harvard Law School, and has a Master of Public Policy degree from Harvard's Kennedy School of Government.

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Appendix B

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[28].

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.[29] 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.[30] 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.[31] 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.

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[28] 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").

[29] 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").

[30] 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").

[31] 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.[32] 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?"[33]

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 (or tax deduction) for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings. Roughly three out of four American households are in the 15%, 10% or zero income tax brackets. (Refundable tax credits would help address this problem, as would even

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

nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions (and voluntary employee contributions to defined benefit plans) under section 25B of the Internal Revenue Code.)

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 C

Treasury's Legislative Cash Balance Proposal

A. Basic Elements

In response to a congressional directive, the Treasury Department suspended work on cash balance regulations and, on February 2, 2004, issued a legislative proposal regarding cash balance conversions. Substantial elements of the Treasury proposal are similar to elements outlined above and in my July 1, 2003 written statement submitted to the Subcommittee. In my view, the Treasury proposal represents a serious and constructive first step toward a solution. Congress should carefully consider a number of the elements in Treasury's proposal when it crafts legislation. However, the Treasury proposal as a whole should not be viewed as meeting the requirements of an adequate solution.

Treasury's proposal would provide that cash balance and other hybrid plans do not violate the age discrimination rules if they satisfy the defined contribution standard for avoiding age discrimination (similar to item 1 in the list of 11 basic elements above). The so-called "whipsaw" restrictions would be eliminated, so that cash balance plans would be permitted to distribute a participant's account balance as a lump sum distribution provided that interest was not credited in excess of a market rate of return (similar to item 9 in the list of basic elements above).

The conversion protections – which would apply only to future conversions -- would take two forms. First, wearaway of the normal or early retirement benefit would be prohibited for all participants (see item 2 above). Second, a "hold harmless" period would apply for the first five years after a future conversion: benefits earned by any employee under the cash balance plan would be required to be at least as valuable as the benefits the employee would have earned under the traditional plan absent the conversion (compare to items 3 and 4, above). A plan sponsor would also satisfy that requirement if it grandfathered current participants under the traditional benefit formula or gave them a choice between the traditional formula and the cash balance formula.

The conversion transition protections would not be plan qualification requirements or, apparently, requirements under Title I of ERISA. Instead, a 100 percent excise tax would be imposed on the plan sponsor equal to any shortfall between the benefits actually provided by the cash balance plan and the benefits required. However, to provide relief to companies "experiencing adverse business conditions," the excise tax would be limited to the greater of the surplus assets of the plan upon conversion or the sponsor's taxable income. The proposal would be effective prospectively, with legislative history stating the

intent that no inference be drawn as to the status of cash balance plans or conversions under current law.

B. Comments

A number of elements in the Treasury proposal invite particular scrutiny. For example --

- While some would regard any required “hold harmless,” grandfathering, or choice as excessive, many would view the five-year limitation on that protection in the Treasury proposal as unduly brief. A long-service participant in his or her fifties or late forties, for example, might well be exposed to a significant reduction for an extended period of employment after the five years have elapsed.

- The conversion protections under the Treasury proposal are not limited to a specified protected class of older and longer-service participants. This gives the proposal the appearance of applying more broadly than many actual or proposed transition provisions that limit the required protection to those participants who have reached a specified age or years of service or both (such as a specified number of age and service “points”). Treasury’s decision not to limit the class of participants required to be protected may well reflect a concern about very substantial discrepancies between the treatment of participants who are on different sides of the eligibility line. The benefits realized by a protected participant from a hold harmless transition provision could be quite significant, and would contrast starkly with the lack of any such benefits for a participant with only a few months less service or age. Others would argue, however, that some element of arbitrary line-drawing is inevitable in this type of undertaking, and that the amount of transition benefit for those who barely qualify for the protected class might be sized appropriately without falling into excessive complexity.

- While the duration of the protective provisions is limited under the proposal, it appears that plan sponsors would not have the flexibility to provide less than the full amount of benefits that participants would have earned under the traditional formula. Some would favor this approach, but others might advocate for allowing employers the flexibility to give something less than full protection during any transition period, i.e., partial continuation or preservation – sufficient to meet a specified standard -- of the benefits that would have been earned under the traditional formula. The Treasury approach would not necessarily accommodate techniques such as age- and service-weighted pay credits that might provide substantial transition relief but less than the full benefit participants would have earned under the traditional formula.

- The apparent decision to omit the protections from the plan qualification rules and Title I of ERISA raises questions regarding enforcement and remedies. An indirect Title I right might arise in certain cases, specifically where the plan provisions reflect the transition protection requirements but the employer fails to comply.

- With respect to the exception for employers with no taxable income, there is a threshold question whether a company in financial distress should be allowed to undertake a conversion without protecting older participants. Some would argue that when plan sponsors need to save money as a matter of survival, it is not important or necessarily desirable as a matter of policy to ensure that they have the option of realizing savings through a cash balance conversion that does not adequately protect older employees (as opposed to other means of saving money, perhaps including more direct reductions in benefits). Others would be swayed by the concern that a likely alternative in such circumstances might be an outright plan termination or freeze, but may nonetheless view the scope of the Treasury exception as unduly broad. As currently described in the Treasury documents, the exception to the excise tax appears to allow avoidance of the protective requirements by plan sponsors that are not in extremis but that have arranged their affairs so as to report little or no taxable income in a given year.

- Many would view the purely prospective nature of the Treasury proposal as desirable (e.g., on the basis that plan sponsors should not be required to have predicted the protective requirements before they were enacted). Others would prefer past conversions to be addressed by legislation in some fashion. Some would contend that at least the plan sponsors that converted after the IRS declared its moratorium on conversion-related determination letters (September 15, 1999) -- and after the public notice shortly thereafter stating that the Treasury and IRS were reconsidering the application of the plan qualification rules to conversions – should be deemed to have been on notice and to have assumed the risk. Others would argue more broadly that participants affected by past conversions undertaken with little or not transition protection should be protected now at least to some practicable extent. Still others would have an interest in a provision making clear that many past conversions – those that met a reasonable and flexible standard specified in legislation – were valid and will be protected from challenge. These issues are discussed in the body of the testimony.