# THE RETIREMENT SECURITY CRISIS: THE ADMINISTRATION'S PROPOSAL FOR PENSION REFORM AND ITS IMPLICATIONS FOR WORKERS AND TAXPAYERS

## HEARING

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

March 2, 2005

**Serial No. 109-3**

Printed for the use of the Committee on Education and the Workforce

Available via the World Wide Web: http://www.access.gpo.gov/congress/house
or
Committee address: http://edworkforce.house.gov

U.S. GOVERNMENT PRINTING OFFICE

99-772 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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# C O N T E N T S

# THE RETIREMENT SECURITY CRISIS: THE ADMINISTRATION'S PROPOSAL FOR PENSION REFORM AND ITS IMPLICATIONS FOR WORKERS AND TAXPAYERS

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**Wednesday, March 2, 2005**
**U.S. House of Representatives**
**Committee on Education and the Workforce**
**Washington, DC**

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The Committee met, pursuant to notice, at 10:06 a.m., in room 2181, Rayburn House Office Building, Hon. John Boehner (Chairman of the Committee) presiding.

Present: Representatives Boehner, Petri, Castle, Johnson, Ehlers, Biggert, Tiberi, Osborne, Kline, Inglis, McMorris, Price, Fortuno, Foxx, Drake, Kuhl, Miller, Kildee, Payne, Andrews, Scott, Woolsey, Hinojosa, Tierney, Kucinich, Wu, Holt, Davis, Grijalva, and Van Hollen.

Staff Present: Stacy Dion, Professional Staff Member; Kevin Frank, Professional Staff Member; Ed Gilroy, Director of Workforce Policy; Richard Hoar, Staff Assistant; Greg Maurer, Coalitions Director; Jim Paretti, Workforce Policy Counsel; Steve Perotta, Professional Staff Member; Molly McGlaughlin Salmi, Deputy Director of Workforce Policy; Deborah L. Emerson Samantar, Committee Clerk/Intern Coordinator; Todd Shriber, Communications Assistant; Kevin Smith, Senior Communications Advisor; Jody Calemine, Minority Counsel, Employer-Employee Relations; Margo Hennigan, Minority Legislative Assistant/Labor; Tom Kiley, Minority Press Secretary; John Lawrence, Minority Staff Director; Michele Varnhagen, Minority Labor Counsel/Coordinator; Daniel Weiss, Minority Special Assistant to the Ranking Member; and Mark Zuckerman, Minority General Counsel.

Chairman BOEHNER. The Committee on Education and the Workforce will come to order.

We're holding this hearing today to hear testimony on the retirement security crisis and the administration's proposal for pension reform and its implications for workers and taxpayers.

Under the Committee rules, opening statements are limited to the Chairman and Ranking Member. If other Members have opening statements, I ask unanimous consent to keep the hearing record open for 14 days so Members can submit their statements.

Without objection, so ordered.

**STATEMENT OF HON. JOHN A. BOEHNER, CHAIRMAN, COMMITTEE ON EDUCATION AND THE WORKFORCE**

I want to thank all of you for coming. I'm looking forward to hearing from our witnesses today.

The impending retirement of the baby boom generation, along with rising life expectancies and declining overall ratio of workers to retirees, has made the issue of retirement security a chief concern for our President, this Congress, and the American people.

President Bush recognizes the retirement security of American workers is more important than partisan politics. That's why he has proposed action on a number of fronts to strengthen worker retirement security, including proposals designed not just to save Social Security, but also to ensure the pension promises made to workers are kept.

While Social Security has received most of the attention, our private pension system also needs significant reform.

It's clear that today's outdated and burdensome pension laws have failed to protect the interests of workers, retirees, and potentially, American taxpayers.

In fact, today's outdated rules actually encourage employers to leave the system, and more and more are doing so at an alarming rate. Without reform, more companies will default on their plans or leave the defined benefit pension system entirely.

This could surely require taxpayer intervention down the road if the financial condition of the Pension Benefit Guaranty Corporation continues to worsen.

We want to ensure that defined benefit plans remain viable for workers, and to do, we need to reform and strengthen this system.

We're entering a new kind of economy, with new kinds of products, services, industries, and business models, and to succeed in this knowledge-and-innovation-driven economy, we need to be able to invest, and we can't do that if outdated pension rules make it impossible for employers to adequately budget for their pension costs from year to year.

So how do we bring our retirement security system, and specifically our defined benefit pension system, into the 21st century economy and encourage employers to continue to offer their workers the best retirement benefits possible? And that's the balance that we're trying to strike.

I'm pleased that the administration recognizes the urgent need to strengthen the defined benefit system and has put forth a comprehensive proposal for single employer reform.

As I've said before, the legislation we'll be introducing in the upcoming weeks and months will not just tinker around the edges of the defined benefit system and leave the most difficult decisions to future generations. We expect that we will have a comprehensive bill that will cover real reform of this system.

It's critical that reforms be focused on our ultimate goal—strengthening retirement security.

The urgency of the PBGC deficit is important, but our efforts will not be focused solely on bolstering the PBGC. Our reform efforts will be focused on reforming outdated rules to improve pension funding, including implementing a permanent method to appropriately calculate plan liabilities, provide stability and predict-

ability in pension funding, and enhance disclosure for workers, especially those in troubled plans.

We're looking to strengthen the overall defined benefit system, not force more employers to abandon their plans or jeopardize the ability of an employee with a troubled plan to recover and provide important benefits to their workers.

After reviewing the administration's proposal, I'm pleased that many of the proposals are similar to the principles for reform I outlined last September. We certainly share the same goals and agree broadly on these principles for reform.

The hearing today will allow us to ask important questions, examine how it would work in practice, and evaluate its impact on pension plans, workers, employers, and the future of the defined benefit system in general.

Our questions will focus on the administration's proposals to reform the funding rules, increase employer premium, and provide new disclosure for workers about the status of their plans.

I note that the administration has not included any reforms to the multi-employer system in its proposal and has chosen to tackle that issue at a future time.

I believe worker pensions in the multi-employer system are being left vulnerable not just because of funding losses over the last several years, but because of structural problems that need significant reform.

The seriousness of the problems within the multi-employer pension system deserves our attention now, and that's why we plan to address both single and multi-employer pension plans in our upcoming legislative proposal.

I have no illusions about the kind of effort that this project will require in this Congress. The short-term pension bill replacing the thirty-year Treasury rate that Congress enacted last year was supposed to be a simple, slam-dunk bill. As you all know, it turned out to be 6 months of long and tenuous negotiations.

Workers, retirees, and taxpayers are relying on us to move quickly and get something accomplished on their behalf. We've got a long year ahead oaf us, but we intend to move quickly.

I look forward to working with the administration as we move forward with comprehensive reforms to strengthen worker retirement security.

With that, I would like to yield to my colleague from California, Mr. Miller.

**STATEMENT OF HON. GEORGE MILLER, RANKING MEMBER, COMMITTEE ON EDUCATION AND THE WORKFORCE**

Mr. MILLER. Thank you very much, Mr. Chairman. Thank you for holding this hearing. It's a continuation of your efforts to direct the resources of this Committee to strengthen retirement security for millions of American workers.

I'm glad today that you mentioned that we would not just be dealing with single employer, but also anticipate working on the problems of the multi-employer plans also.

Security retirement security for millions of Americans is an interest I think that all of us in Congress have, and it's a task that we must meet and we must complete. Securing the average Ameri-

can's retirement is one of the greatest challenges facing this country and this Congress.

The three legs of the retirement platform—Social Security, private pensions, and 401K savings plans—are each under scrutiny, but for different reasons.

President Bush has argued that our cornerstone retirement program, Social Security, is in a crisis and will not pay benefits to younger workers. I and many others strongly agree with his assessment—disagree, excuse me—disagree with his assessment and with his proposal creating private accounts within Social Security.

Social Security faces long-term challenges that must and can be addressed. Meanwhile, however, the real crisis in retirement has received far less attention—the weakness and vulnerability of the traditional pensions and 401K savings plans.

The fact is that Social Security, it can be argued, is the most secure of all of our retirement plans in this country. It covers 96 percent of all Americans and provides over 50 percent of the retirement income for two-thirds of its retirees.

Social Security is funded through 2042 or 2052, and it will continue to have sufficient revenues to pay 80 percent of its promised benefits in perpetuity. No other retirement system in the U.S., whether public or private, can make that kind of promise.

The fact is, not a single company in the Fortune 500 can say that its pension plan—with certainty, that its pension plans—will be funded through 2052 or 2042, or that they can pay 80 percent of all of their benefits in perpetuity.

Even in the best of times, defined benefit plans have never covered more than 50 percent of the workforce and only provided an average of about 20 percent of retirement income.

So we must look at how we must integrate the solutions to all of these problems together.

And now the GAO has put the Pension Benefit Guaranty Corporation on its watch list of high-risk programs for two straight years because the pension insurer has a deficit of over $23 billion and additional possible liabilities of $100 billion.

Meanwhile, total private sector pension under-funding has soared to well over $450 billion.

401K plans are not doing much better. 401K plans have lost over $60 billion since 2000. The median account balance is only $14,000, hardly enough for even 1 year's retirement income.

The 401K assets are being managed by advisors with rampant conflicts of interest who are eating up workers' hard-earned retirement savings with excessive hidden fees, commissions, and financial arrangements.

Our country's traditional enforcement and 401K retirement systems need serious reform. I've been warning about these danger signs for over 2 years. Now is the time for the action. We must strengthen pension plans' funding and shore up the PBGC.

I look forward to hearing the administration describe their pension funding reform proposal today, but from what I've learned so far, I'm concerned that the administration's proposal is fairly harsh medicine and will likely further endanger a very sick patient.

I believe we need to find ways to get most of the under-funded pension plans to improve their funding over time, but I am worried

that the administration's proposal will push plans out of the system, punish workers who do not control the employer funding decisions.

It is one thing to make the plans that are more risky to pay higher insurance premiums to reflect that risk. It is quite another thing entirely, and is quite unfair, to force the weakest plans to bear the burden of paying off PBGC's accumulated deficit. Those costs should be shared among all plans, not just the weakest ones.

PBGC's deficit is in large part because of the global transformations in the steel, textile industries, and quite now possibly the airline industries, and not by any actions of the under-funded employers.

In that sense, I think the President's plan is a non-starter and would likely do more harm than good to those plans.

We need to encourage the employees to stay in the defined benefit plan, not push them out.

Finally, I hope that we will give employees and investors access to up-to-date and accurate information about the financial condition of their private pension plans. Current law says that this must be kept secret.

I believe that is wrong, and I've introduced legislation to make this information public. The President has agreed that it should be made public, and I think the time is now to do that. We need more transparency in this process for the employees and the beneficiaries of these plans.

I look forward to hearing from today's witnesses and am hopeful that the Committee will have full and fair discussions on these issues.

Ms. WOOLSEY. Will the gentleman yield for one comment from me?

Mr. MILLER. Yes.

Ms. WOOLSEY. Thank you.

Mr. MILLER. I guess I have time.

Ms. WOOLSEY. Thank you.

I'd just like to comment on the timeliness of this hearing today.

In the news, Senator Frist was reported as saying that Social Security reform will be put on the back burner for at least a year, and that pension reform is now back on the radar front and center.

Mr. MILLER. I thank the gentlelady.

Chairman BOEHNER. We have two panels of distinguished—

Mr. KUCINICH. Mr. Chairman, will any other Members of the Committee be permitted to give statements?

Chairman BOEHNER. No. Under Committee rules, only the Chairman and the Ranking Member.

Mr. KUCINICH. OK.

Chairman BOEHNER. But any opening statement can be submitted for the record.

I'd like to introduce our first panel of witnesses today.

Our first witness will be the Honorable Ann Combs, who is the assistant secretary of the Employee Benefits Security Administration, or EBSA, at the U.S. Department of Labor.

Before her appointment in May of 2001, Ms. Combs was vice president and chief counsel for retirement and pension issues for the American Council of Life Insurers.

She was also a principal at the William Mercer firm, and also served on the Advisory Council on Social Security, and well-known to most of us in this room.

Our second witness, the Honorable Mark Warshawsky, is the assistant secretary for economic policy at the U.S. Department of the Treasury.

Mr. Warshawsky serves as the Department of Treasury's top economist and advises the Secretary and the deputy secretary on a wide range of economic issues.

Specifically, his office is responsible for reporting on current and prospective economic developments and assisting in the determination of appropriate economic policies.

Previously, Mr. Warshawsky was director of research at TIAA-CREF.

And our third witness today is Mr. Brad Belt. He is the executive director of the Pension Benefit Guaranty Corporation.

As the chief executive officer of the corporation, Mr. Belt is responsible for the PBGC's operations, including administration of two insurance programs covering 31,000 defined benefit plans, plans that are sponsored by private sector employers, providing annual benefit payments of more than $3 billion to nearly one million workers and retirees, and management of assets totaling some $40 billion.

I want to thank all of you for coming, and Ms. Combs, you may begin.

Ms. COMBS. Mr. Chairman, if the Committee will indulge us, we had arranged our testimony, divided it up so that Brad Belt would go first, followed by Assistant Secretary Mr. Warshawsky, and I'm in the cleanup position.

Mr. BELT. I'm the table setter, Mr. Chairman. They're the meat and potatoes.

Chairman BOEHNER. Mr. Belt, why don't you begin?

**STATEMENT OF BRADLEY BELT, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC**

Mr. BELT. Thank you, Mr. Chairman, Ranking Member Miller, and Members of the Committee.

I comment you for your leadership on retirement security issues, and I appreciate the opportunity to discuss the challenges facing the pension insurance program.

My written testimony describes in detail the financial status of the pension insurance program and the flaws in the current funding rules that have led us to this point.

I would like to mention just a few key points that highlight the need for the administration's reform proposal.

The first point is, we've already dug a fairly deep hole and it could get much deeper if we do nothing.

PBGC ended the last fiscal year with an accumulated deficit of just over $23 billion. That is a $30 billion swing in just 3 years, and the most recent snapshot taken by the PBGC finds that corporate America's pension promises are under-funded by more than $450 billion.

More important, $96 billion of this under-funding resides in pension plans at greater risk of termination because the sponsoring company has faced financial difficulties.

I would note, Mr. Chairman, that the risks of further significant losses are not limited to the steel and airline industries. The insurance program's $96 billion in reasonably possible exposure spans a range of industries from manufacturing, transportation, and communications to utilities, wholesale, and retail trade.

It would also be a mistake to assume that these are merely cyclical problems and that a return to the bull markets of the 1990's will save the day.

We cannot predict the future path of financial markets, and even if we could, rising markets would not address the underlying structural flaws in the pension system.

That leads to my second point, that the status quo rules have led to this hearing.

Rather than encouraging strong funding and dampening volatility, attributes like smoothing and credit balances have been primary contributors to systemic under-funding.

The sad fact is that companies can comply with all of the requirements of ERISA and the Internal Revenue Code and still end up with plans that are well below 50 percent funded when terminated.

The system is also rife with what economists call moral hazard.

A properly designed insurance system has mechanisms for encouraging responsible behavior and discouraging risky behavior. The incentives in the pension insurance program, however, run the other way.

In addition, the system suffers from a lack of transparency. The current disclosure rules obfuscate economic reality, shielding relevant information about the funded status of pension plans from participants, investors, and even regulators.

The third and most important point, Mr. Chairman, is that this is not about the PBGC. It is about protecting the pensions that millions of American workers have earned.

The termination of under-funded pension plans can have harsh consequences for workers and retirees. When plans terminate, workers' and retirees' expectations of a secure future may be shattered, because by law, not all benefits promised under a plan are guaranteed.

Other companies that sponsor defined benefit plans also pay a price through higher premiums when under-funded plans terminate. Not only will healthy companies be subsidizing weak companies with chronically under-funded pension plans. They may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor cost onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would cause responsible premium payers to exit the system. If this were to occur, Congress would face pressure to have U.S. taxpayers pay the benefits of workers whose pension plans have failed.

Mr. Chairman, the ultimate question that must be answered is, who will pay for the pension promises that companies have made to their workers? There are only four choices: the company that

made the pension promise; other companies, through higher premiums; participants, through lower benefits; or taxpayers through a rescue of the insurance fund.

The administration believes companies that make pension promises should pay for their pension promises, and not shift those costs to others.

Thank you for inviting me to testify, and I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Belt follows:]

**Statement of Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation, Washington, DC**

Mr. Chairman, Ranking Member Miller, and Members of the Committee: Good morning. I want to commend you for your leadership on retirement security issues, and I appreciate the opportunity to discuss the challenges facing the defined benefit pension system and the pension insurance program, and the Administration's proposals for meeting these challenges.

My colleagues will describe the Administration's comprehensive reform plan in detail, so I would like to take this opportunity to briefly outline some of the reasons why fundamental and comprehensive reform is so urgently needed if we are to stabilize the defined benefit system, strengthen the insurance program, and protect the retirement benefits earned by millions of American workers.

*Introduction*

Private-sector defined benefit plans are intended to be a source of stable retirement income for more than 44 million American workers and retirees. They are one of the crowning achievements of the system of corporate benefit provision that began more than a century ago and reached its apex in the decades immediately following World War II.

That system, however, has on occasion been beset by problems that have undermined the economic security that workers and retirees have counted on. For example, the bankruptcy of the Studebaker car company in the early 1960s left thousands of workers without promised pension benefits. In such cases Congress has been called upon to safeguard the benefits workers were expecting indeed, Studebaker was the catalyzing event that led to the passage of the Employee Retirement Income Security Act (ERISA) and the creation of the Pension Benefit Guaranty Corporation a decade later.

The defined benefit pension system is at another turning point today, and the key issues are largely the same: Will companies honor the promises they have made to their workers? The most recent snapshot taken by the PBGC finds that corporate America's single-employer pension promises are underfunded by more than $450 billion. Almost $100 billion of this underfunding is in pension plans sponsored by companies that face their own financial difficulties, and where there is a heightened risk of plan termination.

Of course, when the PBGC is forced to take over underfunded pension plans, we will provide the pension benefits earned by workers and retirees up to the maximum amounts established by Congress. Unfortunately, notwithstanding the guarantee provided by the PBGC, when plans terminate many workers and retirees are confronted with the fact that they will not receive all the benefits they have been promised by their employer, and upon which they have staked their retirement security. In an increasing number of cases, participants lose benefits that were earned but not guaranteed because of legal limits on what the pension insurance program can pay. It is not unheard of for participants to lose more than 50 percent of their promised monthly benefit.

Other companies that sponsor defined benefit plans also pay a price when underfunded plans terminate. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must ultimately be covered by higher premiums. Not only will healthy companies that are responsibly meeting their benefit obligations end up making transfer payments to weak companies with chronically underfunded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government.

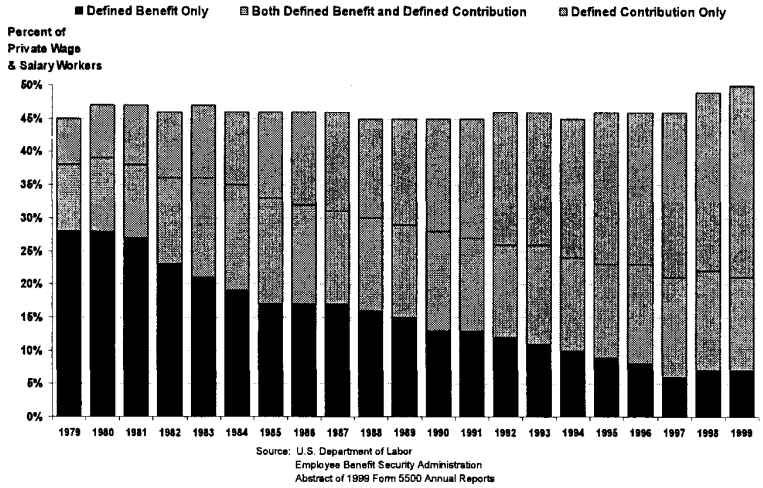
In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers. [1] If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of time. As I will discuss in more detail, the status quo statutory and regulatory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

*State of the Defined Benefit System*

Traditional defined benefit pension plans, based on years of service and either final salary or a specified benefit formula, at one time covered a significant portion of the workforce, providing a stable source of retirement income to supplement Social Security. The number of private sector defined benefit plans reached a peak of 112,000 in the mid–1980s. At that time, about one-third of American workers were covered by defined benefit plans.

**Pension Participation Rates 1979 - 1999**




Source: U.S. Department of Labor
Employee Benefit Security Administration
Abstract of 1999 Form 5500 Annual Reports

In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. In the remaining 2,000 cases companies with underfunded plans shifted their pension liabilities to the PBGC.

Of the roughly 30,000 defined benefit plans that exist today, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers. Some of these sponsors also face challenges due to structural changes in their industries and growing competition from both domestic and foreign companies.

In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured single-employer plans has increased. In 1980, there were about 28 million covered participants, and by 2004 this number had increased to about 35 million. But these numbers mask the downward trend in the defined benefit system because they include not only active workers but also retirees, surviving spouses, and separated vested participants. The latter two categories reflect past coverage patterns in defined benefit plans. A better forward-looking

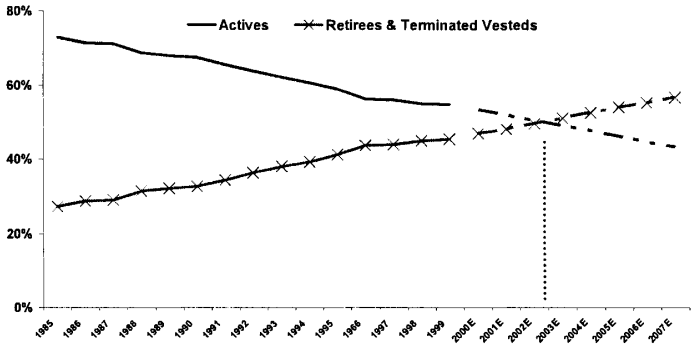
[1] See page 3, Pension Tension, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

measure is the trend in the number of active participants, who continue to accrue benefits. Here, the numbers continue to decline.

In 1985, there were about 22 million active participants in single-employer defined benefit plans. By 2002, the number had declined to 17 million. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 28 percent of total participants in single employer defined benefit plans, a number that has grown to about 50 percent today. In a fully advance-funded pension system, demographics don't matter. But when $450 billion of underfunding must be spread over a declining base of active workers, the challenges become apparent.

**Participants in Defined Benefit Pension Plans**

**[1985 - 2007$^{est.}$]**




Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1999 Form 5500 Annual Reports Spring 2004

The decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system are impacting retirement income security. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly "freezing" plans. Surveys by pension consulting firms show that a significant number of their clients have or are considering instituting some form of plan freeze.[2] Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program.

Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants.[3] Unfortunately, as a result of a single federal court decision, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees.[4]

*The Role of the PBGC*

The PBGC was established by ERISA to guarantee private-sector, defined benefit pension plans. Indeed, the Corporation's two separate insurance programs—for single-employer plans and multiemployer plans—are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 defined benefit plans that have failed since 1974. In this role,

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[2] See, e.g., Aon Consulting, More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So, Oct. 2003; Hewitt Associates, Survey Findings: Current Retirement Plan Challenges: Employer Perspectives (Dec. 2003).

[3] Table S–35, PBGC Pension Insurance Data Book 2004 (to be issued April 2005).

[4] Cooper v. IBM Personal Pension Plan, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. Tootle v. ARINC, Inc., 222 F.R.D. 88 (D. Md. 2004); Eaton v. Onan Corp., 117 F. Supp. 2d 812 (S.D. Ind. 2000).

it is a vital source of retirement income and security for more than 1 million Americans whose benefits would have been lost without PBGC's protection, but who currently are receiving or are promised benefits from the PBGC.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Employee Benefits Security Administration (EBSA). Treasury and EBSA deal with both defined benefit plans and defined contribution benefit plans, including 401(k) plans. PBGC deals only with defined benefit plans and serves as a guarantor of benefits as well as trustee for underfunded plans that terminate. PBGC is also charged with administering and enforcing compliance with the provisions of Title IV of ERISA, including monitoring of standard terminations of fully funded plans.

PBGC is a wholly-owned federal government corporation with a three-member Board of Directors—the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans (generally only pennies on the dollar). The annual insurance premium for single-employer plans has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the amount of a plan's unfunded vested benefits, measured on a "current liability"[5] basis.

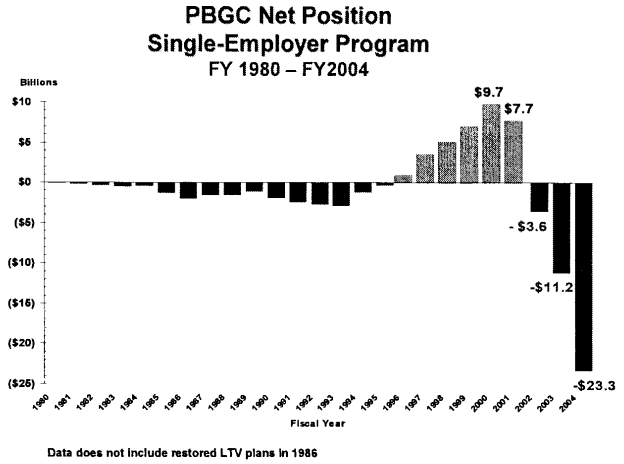
The PBGC's statutory mandates are: 1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants; 2) to provide for the timely and uninterrupted payment of pension benefits to participants; and 3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. In addition, implicit in these duties and in the structure of the insurance program is the duty to be self-financing.

See, e.g., ERISA § 4002(g)(2) (the United States is not liable for PBGC's debts).

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing with no recourse to general tax revenue. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability, which can pit the interests of participants in a particular plan against the interests of those in all plans the PBGC must insure. The PBGC strives to achieve the appropriate balance among these competing considerations, but it is inevitably the case that one set of stakeholder interests is adversely affected whenever the PBGC takes action. The principal manifestation of this conflict is when PBGC determines that it must involuntarily terminate a pension plan to protect the interests of the insurance program as a whole and the 44 million participants we cover, notwithstanding the fact that such an action is likely to adversely affect the interests of participants in the plan being terminated.

The pension insurance programs administered by the PBGC have come under severe pressure in recent years due to an unprecedented wave of pension plan terminations with substantial levels of underfunding. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled $14.7 billion for the year, and the program ended the year with a deficit of $23.3 billion. That is why the Government Accountability Office has once again placed the PBGC's single employer insurance program on its list of "high risk" government programs in need of urgent attention.

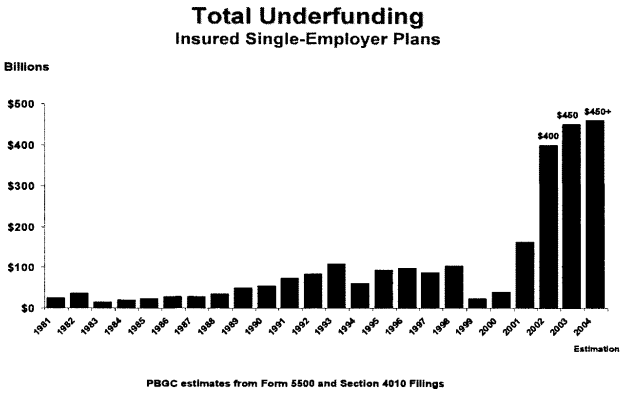
[5] Current liability is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if a plan terminates.




Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with $62 billion in liabilities and only $39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the resources to fully satisfy its benefit obligations.

*Mounting Pressures on the Pension Safety Net*

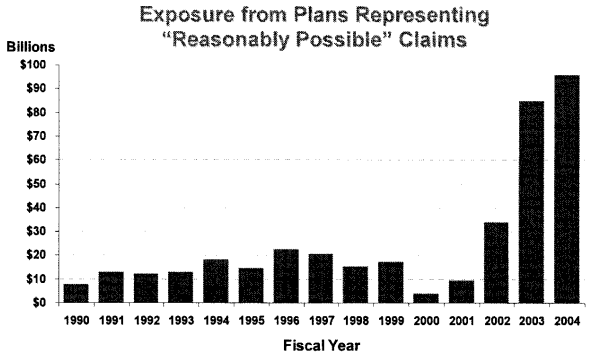
In addition to the $23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than $50 billion. Two years later, as a result of a combination of factors, including declining interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total underfunding exceeded $400 billion.[6] As of September 30, 2004, we estimate that total underfunding exceeds $450 billion, the largest number ever recorded.




Not all of this underfunding poses a major risk to participants and the pension insurance program. On the contrary, most companies that sponsor defined benefit plans are financially healthy and should be capable of meeting their pension obliga-

[6] See page 14, The Magic of Pension Accounting, Part III, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005). "[F]rom 1999 to 2003 the pension plan assets grew by $10 billion, a compound annual growth rate of less than 1%, while the pension obligations grew by $430 billion, a compound annual growth rate of roughly 10%." See also page 2, Pension Tension, Morgan Stanley (Aug. 27, 2004). "DB sponsors were lulled into complacency by inappropriate and opaque accounting rules, misleading advice from their actuaries causing unrealistic return and mortality assumptions, and mismatched funding of the liabilities, and the two decades of bull equity markets through the 1990s veiled true funding needs."

tions to their workers. At the same time, the amount of underfunding in pension plans sponsored by financially weaker employers has never been higher. As of the end of fiscal year 2004, the PBGC estimated that non-investment-grade companies sponsored pension plans with $96 billion in underfunding, almost three times as large as the amount recorded at the end of fiscal year 2002.




The most immediate threat to the pension insurance program stems from the airline industry. Just last month, the PBGC became statutory trustee for the remaining pension plans of US Airways, after assuming the pilots' plan in March 2003. The $3 billion total claim against the insurance program is the second largest in the history of the PBGC, after Bethlehem Steel at $3.7 billion.

In addition, United Airlines is now in its 27th month of bankruptcy and has argued in bankruptcy court that it must shed all four of its pension plans to successfully reorganize. The PBGC estimates that United's plans are underfunded by more than $8 billion, more than $6 billion of which would be guaranteed and a loss to the pension insurance program.

Apart from the significant financial impact to the fund, if United Airlines is able to emerge from bankruptcy free of its unfunded pension liability, serious questions arise as to whether this would create a domino effect with other so-called "legacy" carriers, similar to what we experienced in the steel industry. Indeed, several industry analysts have indicated that these remaining legacy carriers could not compete effectively in such a case and several airlines executives have publicly stated that they would feel competitive pressure to shift their pension liabilities onto the government if United is successful in doing so. Of course, these companies would first have to meet the statutory criteria for distress terminations of their pension obligations.

While the losses incurred by the pension insurance program to date have been heavily concentrated in the steel and airline industries, it is important to note that these two industries have not been the only source of claims, nor are they the only industries posing future risk of losses to the program.

The PBGC's best estimate of the total underfunding in plans sponsored by companies with below-investment-grade credit ratings and classified by the PBGC as "reasonably possible" of termination is $96 billion at the end of fiscal 2004, up from $35 billion just two years earlier. The current exposure spans a range of industries, from manufacturing, transportation and communications to utilities and wholesale and retail trade.[7] Some of the largest claims in the history of the pension insurance program involved companies in supposedly safe industries such as insurance ($529 million for the parent of Kemper Insurance) and technology ($324 million for Polaroid).

[7] In a recent report, Credit Suisse First Boston finds that the auto component and auto industry groups have the most exposure to their defined benefit plans (even more so than airlines). The report notes that "these two industry groups stand out because, compared to others, the degree of their pension plan underfunding is significant relative to market capitalization." See page 60, The Magic of Pension Accounting, Part III, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005).

**Reasonably Possible Exposure**
(Dollars in Billions)

| Principal Industry Categories | FY 2004 | FY 2003 |
|---|---|---|
| Manufacturing | $ 48.4 | $ 39.5 |
| Transportation, Communication & Utilities | 30.5 | 32.9 |
| Services & Other | 7.9 | 2.5 |
| Wholesale and Retail Trade | 5.8 | 4.3 |
| Agriculture, Mining & Construction | 1.9 | 1.8 |
| Finance, Insurance & Real Estate | 1.2 | 1.1 |
| Total | $95.7 | $82.1 |

Some have argued that current pension problems are cyclical and will disappear on the assumption that equity returns and interest rates will revert to historical norms. Perhaps this will happen, perhaps not. The simple truth is that we cannot predict the future path of either equity values or interest rates. It is not reasonable public policy to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves. Similarly, it is not reasonable public policy to base pension funding on the expectation that interest rates will increase dramatically.[8] The consensus forecast predicted that long-term interest rates would have risen sharply by now, yet they remain near 40-year lows.[9] And, a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an alltime high, with more than 90 percent of the exposure unhedged.[10]

More importantly, while rising equity values and interest rates would certainly mitigate the substantial amount of current underfunding, this would not address the underlying structural flaws in the pension insurance system.

*Structural Flaws in the Defined Benefit Pension System*

The defined benefit pension system is beset with a series of structural flaws that undermine benefit security for workers and retirees and leave premium payers and taxpayers at risk of inheriting the unfunded pension promises of failed companies. Only if these flaws are addressed will safety and soundness be restored to defined benefit plans.

*Weaknesses in Funding Rules*

The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded. Simply stated, the current funding rules do not require sufficient pension contributions for those plans that are chronically underfunded. Rather than encouraging strong funding and dampening volatility as some have argued, aspects of current law such as smoothing and credit balances have been primary contributors to the substantial systemic underfunding we are experiencing. The unfortunate fact is that companies that have complied with all of the funding requirements of ERISA and the Internal Revenue Code still end up with plans that are less than 50 percent funded when they are terminated. Some of the problems with the funding rules include:

- The funding rules set funding targets too low. Employers are not subject to the deficit reduction contribution rules when a plan is funded at 90 percent of "current liability," a measure with no obvious relationship to the amount of money

[8] See page 1, Pension Update: Treading Water Against Currents of Change, James F. Moore, PIMCO (Feb. 2005). "Unfortunately things are likely to get worse before they get better. . . As of the beginning of February, the Moody's AA long term corporate index was below 5.50% and 30-year Treasuries were below 4.5%."

[9] Long-term rates have declined in Japan and Europe—to 2.5 percent and 4.0 percent, respectively—two economies facing the same structural and demographic challenges as the United States. See page 1, Pension Update: Treading Water Against Currents of Change, James F. Moore, PIMCO (Feb. 2005).

[10] See page 1, Defined Benefit Pension Plans' Interest Rate Exposure at Record High, Seth Ruthen, PIMCO (Feb. 2005).

needed to pay all benefit liabilities if the plan terminates. In addition, in some cases employers can stop making contributions entirely because of the "full funding limitation." As a result, some companies say they are fully funded when in fact they are substantially underfunded.[11] Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. US Airways' pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. No wonder US Airways pilots were shocked to learn just how much of their promised benefits would be lost.

## Bethlehem Steel

**Termination Benefit Liability Funded Ratio 45%**

**Unfunded Benefit Liabilities $4.3 billion**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| Current Liability Ratio | 78% | 91% | 99% | 96% | 86% | 84% | NR |
| Was the company required to make a deficit reduction contribution? | Y | N | N | N | N | NR | NR |
| Was the company obligated to send out a participant notice? | Y | Y | N | N | N | N | N |
| Did the company pay a Variable Rate Premium? | $15 million | $17 million | N | N | N | N | N |
| Actual Contributions | $354 million | $32.3 million | $30.9 million | $ 8.1 million | $0 | $0 | $0 |
| Debt Rating | B+ | B+ | BB- | BB- | B+ | D | Withdrawn |

## US Airways Pilots

**Termination Benefit Liability Funded Ratio 33%**

**Unfunded Benefit Liabilities $2.5 billion**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| Current Liability Ratio | 97% | 100% | 91% | 85% | 104% | 94% | NR |
| Was the company required to make a deficit reduction contribution? | N | N | N | N | N | N | NR |
| Was the company obligated to send out a participant notice? | N | N | N | N | N | N | N |
| Did the company pay a variable rate premium? | $4 million | N | N | N | $2 million | N | N |
| Actual Contributions | $112.3 million | $0 | $45 million | $0 | $0 | $0 | $0 |

- The funding rules allow contribution holidays even for seriously underfunded plans. Bethlehem Steel made no cash contributions to its plan for three years

[11] Generally, a plan's actuarial assumptions and methods can be chosen so that the plan can meet the "full-funding limitation" if its assets are at least 90 percent of current liability. Being at the full-funding limitation, however, is not the same as being "fully funded" for either current liability or termination liability. As a result, companies may say they are fully funded when in fact they are substantially underfunded. This weakness in the current funding rules is exacerbated by premium rules that exempt plans from paying the Variable Rate Premium (VRP) if they are at the full funding limit. As a result a plan can be substantially underfunded and still pay no VRP. Despite substantial underfunding, in 2003 only about 17 percent of participants were in plans that paid the VRP.

prior to termination, and US Airways made no cash contributions to its pilots' plan for four years before termination. One reason for contribution holidays is that companies build up a "credit balance" for contributions above the minimum required amount. They can then treat the credit balance as a payment of future required contributions, even if the assets in which the extra contributions were invested have lost much of their value. Indeed, some companies have avoided making cash contributions for several years through the use of credit balances, heedlessly ignoring the substantial contributions that may be required when the balances are used up.

- The funding rules rely on the actuarial value of plan assets to smooth plan contribution requirements. However, the actuarial value may differ significantly from the fair market value. Actuarial value is determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of a plan.[12] Masking current market conditions is neither a good nor a necessary way to avoid volatility in funding contributions. Using fair market value of assets would provide a more accurate view of a plan's funded status. I would also note that the smoothing mechanisms in ERISA and financial accounting standards are anomalies—airlines are not allowed to smooth fuel costs; auto companies are not allowed to smooth steel prices; global financial firms are not allowed to smooth currency fluctuations.
- The funding rules do not reflect the risk of loss to participants and premium payers. The same funding rules apply regardless of a company's financial health, but a PBGC analysis found that nearly 90 percent of the companies representing large claims against the insurance system had junk-bond credit ratings for 10 years prior to termination.
- The funding rules set maximum deductible contributions too low. As a result, it can be difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times. (However, this was not a significant issue in the 1990s—a PBGC analysis found that 70 percent of plan sponsors contributed less than the maximum deductible amount.)

*Moral Hazard*

A second structural flaw is what economists refer to as "moral hazard." A properly designed insurance system has various mechanisms for encouraging responsible behavior that will lessen the likelihood of incurring a loss and discouraging risky behavior that heightens the prospects of claims. That is why banks have risk-based capital standards, why drivers with poor driving records face higher premiums, why smokers pay more for life insurance than non-smokers, and why homeowners with smoke detectors get lower rates than those without.

However, a poorly designed system can be gamed. A weak company will have incentives to make generous but unfunded pension promises rather than increase wages. Plan sponsors must not make pension promises that they cannot or will not keep. For example, under current law benefits can be increased as long as the plan is at least 60 percent funded. In too many cases, management and workers in financially troubled companies may agree to increase pensions in lieu of larger wage increases. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years.

Or, labor may choose to bargain for wages or other benefits rather than for full funding of a plan because of the federal backstop.[13] If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund. Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders and much of the downside risk being shifted to other premium payers.

Unfortunately, the pension insurance program lacks basic checks and balances. PBGC provides mandatory insurance of catastrophic risk. Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance underwriting methods. Plan sponsors face no penalties regardless of the risk they impose on the system. As a result, there has been a tremendous amount of cost shifting from finan-

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[12] Page 72, The Magic of Pension Accounting, Part III, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 7, 2005). "Volatility is not necessarily a bad thing, unless it's hidden. . . . Volatility is a fact of doing business; financial statements that don't reflect that volatility are misleading."

[13] See page 3, The Most Glorious Story of Failure in the Business, James A. Wooten, 49 Buffalo Law Rev. 683 (Spring/Summer 2001). "Termination insurance would shift default risk away from union members and make it unnecessary for the UAW to bargain for full funding."

cially troubled companies with underfunded plans to healthy companies with well-funded plans.

Consider: Bethlehem Steel presented a claim of $3.7 billion after having paid roughly $60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a loss to the fund of more than $6 billion.

PBGC cannot control its revenues and cannot control most of its expenses. Congress sets PBGC's premiums, ERISA mandates mandatory coverage for all defined benefit plans whether they pay premiums or not, and companies sponsoring insured pension plans can transfer their unfunded liability to PBGC as long as they meet the statutory criteria.

Not surprisingly, PBGC's premiums have not kept pace with the growth in claims or pension underfunding. The flat rate premium has not been increased in 14 years. And as long as plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the variable-rate premium. That is why some of the companies that saddled the insurance fund with its largest claims ever paid no variable-rate premium for years prior to termination. In fact, less than 20 percent of participants are in plans that pay a VRP.

*Transparency*

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality. That is certainly their effect—to shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two and a half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC does receive more timely information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose at termination are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of its pensions on a firm's earnings capacity and capital structure. While recent accounting changes are a step in the right direction, more can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

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

Finally, the Corporation's ability to protect the interests of plan participants and premium payers is extremely limited, especially when a plan sponsor enters bankruptcy. Currently, the agency has few tools at its disposal other than plan termination. While PBGC has successfully used the threat of plan termination to prevent instances of abuse of the pension insurance program, it is a very blunt instrument. Plan termination should be a last resort, as it means that participants will no longer accrue benefits (and may lose benefits that have been promised) and the insurance programs takes on losses that might have been avoidable.

*Conclusion*

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, "the Company has done everything required by law[14] to fund its pension plans, which are underfunded by more than $8 billion.

That, Mr. Chairman, is precisely why the rules governing defined benefit plans are in need of reform. At stake is the viability of one of the principal means of predictable retirement income for millions of Americans. The time to act is now. Thank you for inviting me to testify. I will be pleased to answer any questions.

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Chairman BOEHNER. Thank you.

Mr. Warshawsky.

**STATEMENT OF MARK WARSHAWSKY, ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC**

Mr. WARSHAWSKY. Good morning, Chairman Boehner, Ranking Member Miller, and Members of the Committee. I appreciate the opportunity to participate in this hearing to discuss the administration's proposal to reform and strengthen the single-employer defined benefit pension system.

The primary goal of any pension reform effort should be to ensure that retirees and workers receive the pension benefits that they have been promised and earned. Clearly, the current funding rules have failed to meet this goal.

As part of its reform proposal, the administration has designed a new set of funding rules that we think will ensure that participants will receive the benefits they have earned from their pension plans.

Today, I'll briefly discuss a few critical issues pertaining to these funding rules, while my colleague, Ann Combs, will discuss the other elements of the proposal.

For any set of funding rules to function well, assets and liabilities must be measured accurately. The system of smoothing embodied in current law serves only to mask the true financial condition of pension plans and to shift the risk of unfunded liabilities from firms that sponsor under-funded plans to plan participants and other sponsors in the insurance system.

Under our proposal, assets will be marked to market; liabilities will be measured using a current spot yield curve that takes account of the timing of future benefit payments summed across all plan participants.

Discounting future benefit cash-flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability, liabilities computed using the yield curve matched to the timing of obligations with discount rates of appropriate maturities.

Proper matching of discount rates and obligations is the most accurate way to measure today's cost of meeting pension obligations.

Use of the yield curve is a prudent and common practice. Yield curves are regularly used in valuing other financial instruments

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[14] Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

and obligations, including mortgages, certificates of deposit, and so on.

The administration recognizes that the current minimum funding rules have contributed to funding volatility. Particular problem areas are the deficit reduction contribution mechanism and the limits on tax deductibility of contributions.

Our proposal is designed to remedy these issues by giving the plans the tools needed to smooth contributions over the business cycle.

These tools include increasing the deductible and contribution limit that will give plan sponsors additional ability to fund during good times, increasing the amortization period for funding deficits to 7 years compared to a period as short as 4 years under current law, and the freedom plans already have to choose prudent pension fund investments.

Plan sponsors may choose to limit volatility by choosing an asset allocation strategy or a conservative funding level so that financial market changes will not result in large increases in minimum contributions.

We believe these are the appropriate methods for dealing with risk. It is inappropriate to limit contribution volatility by transferring risk to plan participants and the PBGC.

Under our proposal, plan funding targets for healthy plan sponsors will be established at a level that reflects the full value of benefits earned to date under the assumption that plan participant behavior remains largely consistent with past history of an ongoing concern.

Plans sponsored by firms with below-investment-grade credit will be required to fund to a higher standard that reflects the increased risk that these plans will terminate.

Pension plans sponsored by firms with poor credit ratings post the greatest risk of default. It is only natural that pension plans with sponsors that fall into this readily observable, high-risk category should have more stringent funding standards.

Credit ratings are used throughout the economy and in many government regulations to measure the risk that a firm will default on its financial obligations. A prudent system of pension regulation insurance would be lacking if it did not use this information.

Credit balances are created when a plan makes a contribution that is greater than the required minimum. Under current law, a credit balance plus an assumed rate of return can be used to offset future contributions.

We see two problems with this system.

First, the assets that underlie credit balances may lose, rather than gain value.

Second, and far more important, credit balances allow plans that are seriously under-funded to take funding holidays.

In our view, every under-funded plan should make minimum annual contributions, and under our proposal they will do so, but contribution in excess of the minimum still reduce future minimum contributions.

It has been my pleasure to discuss this proposal today. My colleagues and I look forward to answering any questions you may have.

[The prepared statement of Mr. Warshawsky follows:]

**Statement of Mark J. Warshawsky, Assistant Secretary for Economic Policy, U.S. Department of the Treasury, Washington, DC**

Good afternoon Chairman Boehner, Ranking Member Miller, and members of the Committee. I appreciate the opportunity to participate in this hearing to discuss the Administration's proposal to reform and strengthen the single employer defined benefit pension system. In my testimony, I will focus on the proposal's funding rules, in particular, the calculation of the funding targets.

The single employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action, ultimately the insurance system will simply not have adequate resources to pay all the benefits that it owes to the one million workers and retirees currently owed benefits who were participants of failed plans and to the beneficiaries of plans that fail in the future.

The Administration believes that current problems in the system are not transitory nor can they be dismissed as simply the result of restructuring in a few industries. The cause of the financial problems is the regulatory structure of the defined benefit system itself. Correcting these problems and securing the retirement benefits of workers and retirees requires that the system be restructured. Minor tinkering with existing rules will not be sufficient. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system to make it financially sound.

A defined benefit pension plan is a trusteed arrangement under which an employer makes a financial commitment to provide a reliable stream of pension payments to employees in exchange for their service to the firm. One cannot expect that such obligations will be honored consistently if they are allowed to remain chronically underfunded as they are under current law. The incentives for financially sound plan funding must be improved or we will continue to see pension plans terminating with massive amounts of unfunded benefits. These unfunded benefits are costly both to participants because many lose benefits and also to other pension sponsors because, they are likely bear the higher costs that such underfunding imposes on the insurance system through even higher premiums.

The goal of the Administration's proposed defined benefit pension reform is to enhance retirement security. The reforms are designed to ensure that plans have sufficient funds to meet accurately and meaningfully measured accrued obligations to participants. The current defined benefit pension funding rules—which focus on micromanaging annual cash flows to the pension fund—are in need of a complete overhaul. The current rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The current rules:

- Measure plan assets and liabilities inaccurately.
- Fail to ensure adequate plan funding.
- Fail to allow sufficient contributions by plans in good economic times, making minimum required contributions rise sharply in bad economic times.
- Permit excessive risk of loss to workers.
- Are burdensome and unnecessarily opaque and complex.
- Do not provide participants or investors with timely, meaningful information on funding levels.
- Do not generate sufficient premium revenues to sustain the PBGC.
- Create a moral hazard by permitting financially troubled companies with underfunded plans to make benefit promises they cannot keep.

The President's solution to these issues is to fundamentally reform the rules governing pension plan funding, disclosure and PBGC premiums, based on the following three simple principles:

- Funding rules should ensure pension promises are kept by improving incentives to fund plans adequately.
- Workers, investors and pension regulators should be fully aware of pension plan funding status.
- Premiums should reflect a plan's risk and ensure the pension insurance system's financial solvency.

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and as a result will moderate future insurance costs that will be borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding.

We have proposed a fundamental reform of the treatment of defined benefit pension plans, one that we believe will change plan sponsor behavior, ultimately result in better funded and better managed defined benefit pension plans, and secure benefits for workers and retirees.

The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target—a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund-up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

Some key features of the proposed funding rules:

- Funding based on meaningful and accurate measures of liabilities and assets. The proposal provides funding targets that are based on meaningful, timely, and accurate (using the yield curve for discounting is a central component of this proposal) measures of liabilities that reflect the financial health of the employer.
- Accrued benefits funded. Sponsors that fall below minimum funding levels will be required to fund up within a reasonable period of time. The proposal requires a 7-year amortization period for annual increases in funding shortfalls. There will be restrictions on the extension of new benefit promises by employers whose plans' funded status falls below acceptable levels. Benefit restrictions will limit liability growth as a plan becomes progressively underfunded relative to its funding target.
- Plan sponsors able to fund plans during good times. Many believe that the inability of plan sponsors to build sufficiently large funding surpluses during good financial times under current rules has contributed to the current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. And every plan will be allowed to fund to a level of funding corresponding to the total cost of closing out the plan. Under our proposal, allowing plan sponsors the opportunity to prefund and therefore limit contribution volatility is a critical element.

Some argue that the best way to enhance retirement security is to create the appearance of well funded pension plans through the use of asset and liability smoothing and increased amortization periods for actuarial losses. In addition, plan sponsors have frequently voiced their dislike of volatile and unpredictable minimum contributions.

Our view is there are significant risks associated with masking the underlying financial and economic reality of underfunded pension plans. Failure to recognize risk because of the use of smoothing mechanisms results in transfers of risk among parties, in particular from plan sponsors to plan participants and the PBGC. One need only look at the losses incurred by many steel and airline plan participants and PBGC's net position to see this is so.

Moreover, the Administration recognizes that the current minimum funding rules—particularly the deficit reduction contribution mechanism and the limits on tax deductibility of contributions—have contributed to funding volatility. Our proposal is designed to remedy these issues; for example, we increase the deductible contribution limit. We feel this additional ability to fund during good times, combined with other provisions of the proposal; for example, increasing the amortization period to seven years compared to a period as short as four years under the current law deficit reduction contribution mechanism, together with the existing freedom of plans have to choose pension fund investments, will give plans the tools they need in order to smooth contributions over the business cycle. Plans may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions. These are appropriate methods for dealing with risk; it is inappropriate to limit contribution volatility by transferring risk to participants and the PBGC.

*Meaningful and Accurate Measures of Assets and Liabilities*

We propose measuring liabilities on an accrual basis using a single standard liability measurement concept that does not distort the measures by smoothing values over time. Within the single method, liability is measured using assumptions that are appropriate for a financially healthy plan sponsor (investment grade credit rated), and alternatively using assumptions that are appropriate for a less healthy

plan sponsor (below investment grade) that is more likely to find itself in a position of default on pension obligations in the short to medium term.

On-going liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay. Salary projections would not be used in determining the level of accrued benefits. Expected benefit payments would be discounted using the corporate bond spot yield curve that will be published by the Treasury Department based on market bond rates. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the current liability measure under current law, plans would be required to recognize expected lump sum payments in computing their liabilities.

The at-risk liability measure estimates the liabilities that would accrue as a plan heads towards termination because of deteriorating financial health of the plan sponsor. At-risk liability would include accrued benefits for an ongoing plan, plus increases in costs that occur when a plan terminates. These costs include acceleration in early retirement, increase in lump sum elections when available and the administrative costs associated with terminating the plan.

The following table provides a summary overview of the critical differences between the ongoing and at-risk liability assumptions.

| | *Ongoing Liability* | *At-Risk Liability* |
|---|---|---|
| Discount Rate | ---------- Yield Curve ---------- | |
| Mortality Assumptions | ---------- Set by Law ---------- | |
| Retirement Assumptions | Developed using relevant recent historical experience. | Acceleration in retirement rates – individuals retire at the earliest early retirement opportunity. |
| Lump Sum Payments | Developed using relevant recent historical experience. | Acceleration in lump-sum election. |
| Transaction Costs | Not included | Included. Calculated by formula. |

Under our proposal, assets will be valued based on market values on the valuation date for determining minimum required and maximum allowable contributions. No smoothed actuarial values of assets will be used as they mask the true financial status of the pension plan.

One aspect of our liability measurement approach that has received a fair amount of attention is the use of the yield curve to discount pension plan liabilities. Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: they must reflect the timing of the future payments, and they should be based on current market-determined interest rates for similar obligations. The Administration proposes to replace the current law method with a schedule of rates drawn from a spot yield curve of high grade (AA) corporate bonds averaged over 90 business days. Discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because, by matching the maturity of the discount rate with the timing of the obligation, it properly computes today's cost of meeting that obligation. Use of a yield curve is a prudent and common practice; yield curves are regularly used in valuing other financial instruments including mortgages, certificates of deposit, etc.

The Treasury Department has developed a corporate bond yield curve that is appropriate for this purpose. Our methodology allows spot yield curves to be estimated directly from data on corporate AA bonds. The process incorporates statistically unbiased adjustments for bonds with embedded call options, and allows for statistically unbiased projections of yields beyond a 30-year maturity. We recently published a white paper detailing our methodology (Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of The Treasury, Office of Economic Policy, White Paper, February 7, 2005) that is available on the Treasury Department web site.

Our budget proposal to reform the calculation of lump-sum benefits also uses the yield curve for calculating the minimum lump sums. We propose to replace the use of a 30-year Treasury rates for purposes of determining lump sum settlements under qualified plans. Using the yield curve to compute lumps sums and the funding required for an annuity eliminates any distortions that would bias the participant's payout decision. Under our proposal, lump sum settlements would be calculated using the same interest rates that are used in discounting pension liabilities: interest rates that are drawn from a zero-coupon corporate bond yield curve based on the interest rates for high quality corporate bonds. This reform includes a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law. The new basis would not apply to distributions in 2005 and 2006

and would be phased in for distributions in 2007 and 2008, with full implementation beginning only in 2009.[1]

*An Example of Discounting Liabilities Using the Yield Curve*

Today, I'll provide an example (economists call this a stylized example) of how the yield curve would be used in discounting pension obligations. The yield curve is used to discount the plans aggregate expected pension payments in each year to participants. The plan administrator has calculated these future pension payments based on the plan's formula for benefits that participants have earned up to the valuation date. As this example shows, once the actuary has determined the plan's annual cash benefit payments summed over all participants in a manner similar to what is done under current law, discounting those payments using the yield curve is quite simple.

Our hypothetical plan consists of three individuals, the 64-year-old Mr. Brown, the 59-year-old Ms. Scarlet, and the 54-year-old Mr. Green. Each of the three retires at age 65 and receives the same pension benefit payment each year until death at age 80. The benefit Mr. Brown has earned to date is higher than Ms. Scarlet's (it is assumed that he has been working longer under the plan) whose expected benefit is in turn larger than Mr. Green's. Mr. Brown's annual benefit under the plan is $12,000, Ms. Scarlet's is $9,000 and Mr. Green's is $6,000.

Chart 1 shows the AA corporate bond yield curve that would be used to discount these benefit payments. The yield curve has interest rates for years 0 to 80. For our stylized example we will only need to use points for the years 1 through 26 because we assume that no participant will draw benefits before year 1 and all payments will be made by year 26. The example applies the yield curve to payments made each year.

**Chart 1**

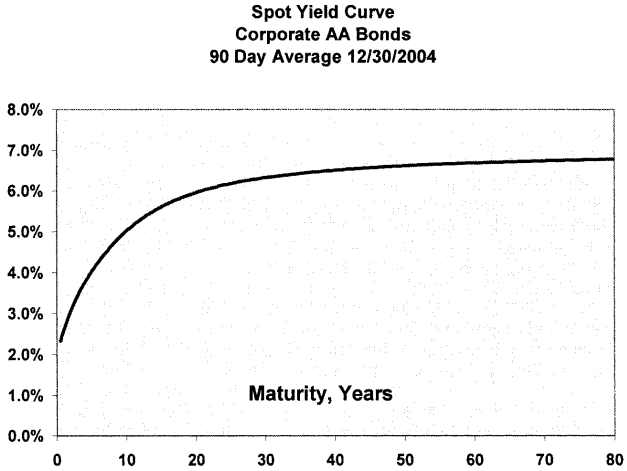



Chart 2 shows the benefit payments that each participant is expected to receive in the future. Chart 3 shows expected total payments that will be made by the plan each year in the future; this is simply the sum of payments to the three individual participants. The total benefit line takes an upward step each time a participant retires and a downward step each time a participant's benefit ends.

[1] This is a different yield curve phase-in schedule than proposed for the use of the yield curve in discounting pension liabilities for minimum funding purposes.

**Chart 2**

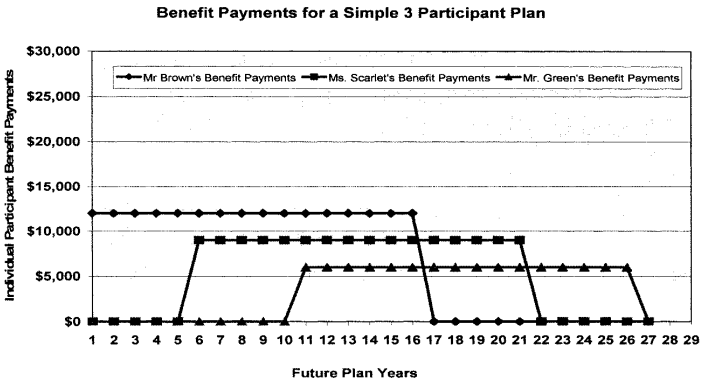
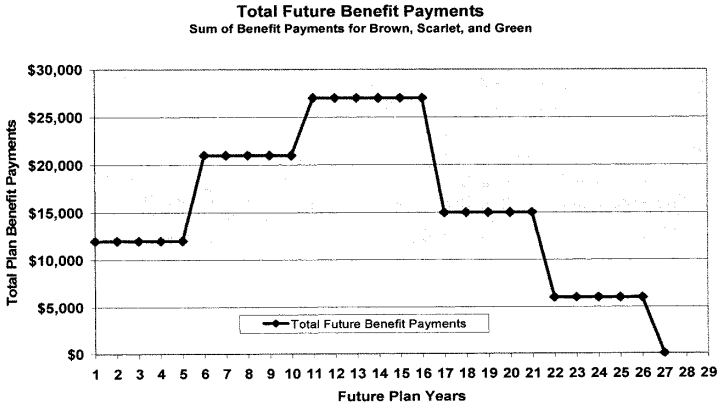



**Chart 3**




How do we apply the yield curve to discounting these benefit payments?

Let's take years 5, 14 and 20. In year 5, the plan expects to pay $12,000 in benefits, all to Mr. Brown. The discount rate for that year drawn from the yield curve is 4.03 percent. To compute the present value of the $12,000, the $12,000 is divided by 1.218 (one plus the interest rate expressed in decimal form, 1.0403, raised to the 5th power), which equals $9,849.

For plan year 14 the expected benefit payments are $27,000 ($12,000 to Mr. Brown, $9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the yield curve interest rate is 5.51 percent. To compute the present value, the $27,000 is divided by 2.119 (1.0546 taken to the 14th power) yielding $12,742. For year 20, the plan expects to pay $15,000 ($9,000 to Ms. Scarlet and $6,000 to Mr. Green) and the discount rate from the yield curve is 5.96 percent. Dividing $15,000 by 3.183 gives a present value of $4,713. Note that even though there are three participants in the plan, once their benefit payments during any period are added together only one interest rate is needed to compute the present value for that period. Separate interest rates are not used for every individual participant in the plan.

In order to compute the plan's target liability the plan needs to perform computations like the one above for each payment period from 1 through 27 and sum them together. The liability for this hypothetical plan is $238,994. In this example, only 26 interest rates are used, one for each year that benefit payments are made. Even if our hypothetical plan had thousands of participants, but payments were made for only 26 years in the future, only 26 interest rates would be needed to compute the plan's liability.

This is, of course, a simplified example. The plan actuary needs to make a number of computations and use his or her professional judgment to determine the plan's

future benefit payments each year: the actuary must estimate the probability that a participant will retire at a particular time in the future and must model the probable pattern of payments that will be made for that participant until the participant's death. These computations, already required by current law, are complex, but once the actuary has determined the annual cash benefit payments, discounting those payments using the yield curve is quite simple and can easily be done using a basic spreadsheet program.

As noted above, if Mr. Brown elected to take a lump sum payment rather than an annuity, the minimum value of that lump sum would also be computed using the yield curve. We have assumed that Mr. Brown will begin receiving his annual benefit of $12,000 next year and will receive the same benefit for 16 years. In order to compute the value of those future payments as a lump sum we would simply discount each period's cash flows using interest rates drawn from the yield curve to find the present value of the benefit in each future period. Then we sum those present values together to yield the minimum lump sum value. In year one, for example, the interest rate drawn from the yield curve is 2.59 percent. If the first $12,000 payment is made one year in the future its present value would be $11,697. The present value of the payment made in year 5 would be computed using the year 5 point on the yield curve that is 4.03 percent. Its present value would be $9,849. In year 12, the interest rate used to compute the present value is 5.29 percent and therefore the present value of the benefit payment is $6,465. In total, Mr. Brown's hypothetical lump sum would be valued at $131,035.

*Distinction by Credit Rating*

Under the Administration's proposal, the appropriately measured accrued liabilities serve as the plan funding targets. The target funding level for minimum required contributions will vary depending on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below investment grade rated) will use 100 percent of at-risk liability as their funding target.[2]

The goal of pension funding rules is to minimize benefit losses to plan participants. When pension plans default on their obligations, the PBGC is required to make benefit payments to plan participants subject to the guarantee limits. Ultimately, if plan defaults are too numerous, the insurance system will collapse and taxpayers may be called upon to fund the pension promises. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of such defaults. Therefore, it is only natural that pension plans with sponsors that fall into this readily observable high risk category should have more stringent funding standards. The at-risk liability measure is an appropriate funding target for below investment grade companies because the target reflects the plan liabilities that would accrue as a plan heads towards termination.

The table below shows the average cumulative default rate of corporate bond issuers as computed by Moody's Investor's Service (January 2005). This table indicates that, over time, below investment grade firms have a substantially higher likelihood of default than investment grade firms. The table indicates that 14.81 percent of Ba rated firms (just below investment grade) experience a default within 7 years, whereas only 3.12 percent of Baa rated firms (just above investment grade) experience a default within the same period.

**Average Cumulative Default Rate by Credit Rating, 1970-2004**
**Selected Data**

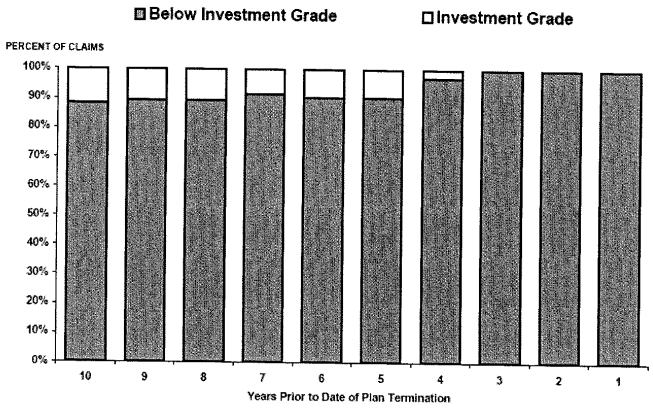
| *Years* | *Moody's Credit Rating* | | | | | | |
|---|---|---|---|---|---|---|---|
| | Aaa | Aa | A | Baa | Ba | B | Caa-C |
| 1 | 0.00 | 0.00 | 0.02 | 0.19 | 1.22 | 5.81 | 22.43 |
| 3 | 0.00 | 0.03 | 0.22 | 0.98 | 5.79 | 19.51 | 46.71 |
| 5 | 0.12 | 0.20 | 0.50 | 2.08 | 10.72 | 30.48 | 59.72 |
| 7 | 0.30 | 0.37 | 0.85 | 3.12 | 14.81 | 39.45 | 68.06 |
| 10 | 0.63 | 0.61 | 1.48 | 4.89 | 20.11 | 48.64 | 76.77 |
| 15 | 1.22 | 1.38 | 2.74 | 8.73 | 29.67 | 57.72 | 78.53 |
| 20 | 1.54 | 2.44 | 4.87 | 12.05 | 37.07 | 59.11 | 78.53 |

Source: Moodys Investor Services, Global Credit Research, Default and Recovery Rates of Corporate Bond Issuers, 1920-2004, January 2005.

[2] The proposal includes a detailed description of the transition rules that govern the phase in of the higher funding target when a plan changes status from ongoing to at-risk. See the Treasury Blue Book for more information at http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf.

The following chart shows that firms generally have a below investment grade credit rating for several years prior to their plan default on pension obligations triggering a claim on the PBGC. This shows 27 largest claims to PBGC for which the series of S&P ratings were available. This suggests that while defaults are certainly not easily predictable (many other plans with below investment grade credit ratings did not default), these are clear warning signs that any responsible regulatory system should take into account. Differentiating funding targets based on credit ratings is appropriate and the investment grade/below investment grade distinction is the most useable and accurate breakpoint.

**Chart 4**
**Debt Ratings for 27 Large PBGC Claims**




Source: PBGC

*Accrued Benefits Funded*

Under the proposal, sponsors that fall below minimum funding levels would be required to fund up towards their appropriate target in a timely manner. If the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments would be required in amounts that amortize the funding shortfall over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of future amortization payments is less than the funding target, that shortfall is amortized over the following 7 years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.[3]

It is critical to note that while our proposal does away with "credit balances" as currently construed, it does not reduce the incentives to contribute above the minimum. It does, however, prevent underfunded plans from using credit balances for funding holidays. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have resulted in plans having lengthy funding holidays, while at the same time becoming increasingly underfunded. Just marking credit balances to market is not sufficient to solve the problem if underfunded plan are still able to take funding holidays. In the Administration proposal, the focus of the reformed funding rules on stocks of assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Under a reformed set of funding rules, pre-funding adds to a plan's

[3] This description draws on the description in the Treasury Blue Book.

stock of assets, thereby reducing any current shortfalls or the likelihood of potential future shortfalls relative to appropriately and accurately measured liabilities.

*An Example of Funding Rules*

Using another example we can demonstrate how minimum contributions would be determined under the funding proposal. Liabilities for the plan are computed over a five-year period using the cash flows and the yield curve depicted in the graphs above. (For simplicity, it is assumed that the yield curve interest rates remain constant over the five-year period.) We then begin with an arbitrarily chosen level of plan underfunding to demonstrate how the amortizations of plan deficits would work. For this example, we simplify and assume that the interest rate charged for amortization of shortfalls is zero. That means that a shortfall increase payment amortized over 7 years is merely the increase divided by 7. The normal cost is also assumed to be zero to simplify the exposition.

In year one, the plan is underfunded by $18,994. That means that the plan must contribute a minimum of $2,713, which is the amortization payment for $18,994 over a seven year term—in year one and for the next six years—unless the plan becomes fully funded before year seven.

In year two, the plan's funding deficit is $8,000 as a result of increases in both the value of assets and liabilities. Since this new shortfall is less than the value of future contributions (we assume that the plan will make future contributions so their present value effectively becomes an asset) the increase in the shortfall is zero. Under the amortization rules no new payment is required; because the plan is still underfunded, however, a second payment of $2,713 must be made. The amortization rule is designed to encourage plans to fund up quickly in order to protect participants' pensions. For that reason, the amortization payment of $2,713 is not reduced even though the plan's funded status has improved.

In year 3, the funding shortfall increases to $18,367 because the value of assets has fallen. Because this is $4,800 more than the value of the remaining amortization payments, a new payment of $686 is added to the existing payment of $2,713 meaning that total contributions are $3,399 in year 3.

In year 4, because of an increase in asset values, the plans deficit falls to $9,283. This is less than $14,968, the value of the remaining shortfall payments from year 1 and year 3 so there is no new payment and the required contribution remains $3,399.

In year 5, asset values rise again and the plan is now fully funded. Because the plan no longer has a funding deficit, no minimum contribution is required and all past amortization payments are cancelled.

**Table 2**
**Minimum Funding Example**

| Year | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| **Assets** | **$220,000** | **$242,000** | **$225,060** | **$236,313** | **$250,492** |
| **Liabilities** | **$238,994** | **$250,000** | **$243,427** | **$245,596** | **$247,656** |
| **Shortfall** | **$18,994** | **$8,000** | **$18,367** | **$9,283** | **$0** |
| **Value of Remaining Year 1 Pmts.** | | $16,281 | $13,567 | $10,854 | $8,140 |
| **Value of Remaining Year 2 Pmts.** | | | $0 | $0 | $0 |
| **Value of Remaining Year 3 Pmts.** | | | | 4,114 | 3,429 |
| **Value of Remaining Year 4 Pmts.** | | | | | $0 |
| **Value of All Remaining Payments** | $0 | $16,281 | $13,567 | $14,968 | $11,569 |
| **Shortfall Increase** | **$18,994** | **$0** | **$4,800** | **$0** | **$0** |
| **Minimum Contribution for:** | | | | | |
| **Year 1 Shortfall Increase** | $2,713 | $2,713 | $2,713 | $2,713 | $0 |
| **Year 2 Shortfall Increase** | | $0 | $0 | $0 | $0 |
| **Year 3Shortfall Increase** | | | $686 | $686 | $0 |
| **Year 4 Shortfall Increase** | | | | $0 | $0 |
| **Year 5 Shortfall Increase** | | | | | $0 |
| **Total Minimum Contribution** | **$2,713** | **$2,713** | **$3,399** | **$3,399** | **$0** |

*Benefit Restrictions*

Finally, we have proposed benefit restrictions that will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of liabilities when plans are becoming dangerously underfunded in order to ensure that plan participant will collect benefits that they accrue. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in many situations even make benefit improvements. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likely losses faced by participants and large claims to the PBGC. To guard against this type of moral hazard, if a company's plan is poorly funded, the growth in the plan's liabilities should be limited unless and until the company funds them, especially if the company is in a weak financial position.

*Plan sponsors able to fund plans during good times*

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The importance of these mechanisms that I have described is not simply to force plans to fund-up quickly and reduce the rate at which new obligations accrue. Their importance is also that rational, forward looking managers will respond to these reforms by taking steps to ensure that plans remain well funded on an ongoing basis. The Administration plan matches new responsibilities, to more fully fund pension obligations, with new opportunities—an enhanced ability to pre-fund obligations on a tax preferred basis.

Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed significantly to current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. Every plan will be allowed to fund to at least at-risk Liability.

The first cushion is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability values fluctuations that occur over a business cycle. Plan sponsors would also be able to build a second funding cushion that allows them to pre-fund for salary or benefit increases.

*Conclusion*

Defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the future. We are committed to working with Congress to ensure that effective defined benefit pension reforms that protect worker's pensions are enacted into law.

It has been my pleasure to provide this detailed discussion of some of the critical elements of the proposal. My colleagues and I are available and look forward to discussing the proposal and the motivations for the proposal and answering any additional questions you may have.

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Chairman BOEHNER. Thank you.

Ms. Combs.

## STATEMENT OF ANN COMBS, ASSISTANT SECRETARY OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, WASHINGTON, DC

Ms. COMBS. Good morning, Chairman Boehner, Mr. Miller, and Members of the Committee. Thank you for inviting us today to discuss the administration's proposal.

As you've noted, the defined benefit system needs comprehensive reform. Mere tinkering with the current rules will not fix its problems.

The administration's reform package will improve pension security for workers and retirees, stabilize the defined benefit system, and avoid the need for a taxpayer bailout of the PBGC.

I will focus today on three elements of the proposal: preventing hollow benefit promises by severely under-funded pension plans; improving disclosure to workers, investors, and regulators; and reforming PBGC premiums to better reflect the real risks and costs of the pension guarantee program.

Under the current funding rules, financially weak companies can promise new benefits and make lump-sum payments that the plan cannot afford. Workers, retirees, and their families who rely on these empty promises can face serious financial hardship if the pension plan is terminated.

The administration's proposal would prevent this by ensuring that companies make promises they can afford and keep the promises they make.

First, the proposal would allow a plan to increase benefits only if the plan is more than 80 percent funded or if the new benefits are fully and immediately paid for.

Second, a plan could not make lump-sum payments unless it is more than 60 percent funded, or if the plan sponsor is financially week, more than 80 percent funded. This will ensure that workers are treated fairly, preventing a run on the bank where a few collect at the expense of those left behind in the plan.

Third, plans sponsored by financially weak companies that are less than 60 percent funded would have no new benefit accruals until their funded status improves, and plans sponsored by bankrupt companies would be frozen until the plans were fully funded.

Our proposal also prevents corporate executives from securing their own retirements while workers' plans are at risk, an abuse recently seen in the airline industry.

Financially weak companies with severely under-funded plans could not secure non-qualified deferred executive compensation arrangements, and funds used for this purpose could be recovered by the under-funded pension plan.

Plans that become subject to any of these benefit limitations would be required to notify affected workers, making them aware that deteriorating funding is threatening their benefits.

These restrictions create a strong incentive for employers to adequately fund their plans, and they ensure that the promises already made to workers are honored before additional empty promises are made, raising false expectations that cannot be met.

The financial health of defined benefit plans must be transparent and fully disclosed to workers and retirees as well as to regulators and investors.

The administration's proposal would accelerate and improve annual disclosures to covered workers and retirees. Each plan would disclose its funded status relative to its funding target for the current year and for the two preceding years, along with information about the companies' financial health and PBGC guarantees.

These disclosures will ensure that workers have the information they need to talk to their employers about the funding of their plans and to make informed choices about their own retirements.

It will correct the current situation, where so many workers and retirees have lost benefits with little or no advance warning, having been told that their plans were adequately funded.

Another key reform is to improve the timeliness and accuracy of annual plan reports to the government.

Under current law, the information reported doesn't accurately measure assets and liabilities, and can be nearly 2 years out of date.

We would require plans to report annually the market value of their assets and the ongoing and at-risk liability—value of their liabilities, as well as shorten the deadline for large under-funded plans to report their actuarial information.

In addition, our proposal allows information filed by certain under-funded plans with the PBGC to be disclosed to the public, except for sensitive information such as trade secrets that is protected under the Freedom of Information Act.

Finally, our proposal will restore the financial integrity of the Federal insurance system by improving the PBGC premium structure.

It would immediately adjust the flat, per-participant annual premium to $30 to reflect the growth in worker wages since 1991 when the current $19 figure was set. The rate would be indexed to wage growth, similar to the way the PBGC guarantee limit is indexed.

All companies with under-funded plans would pay an additional risk-based premium based on the plan's funding shortfall. The rate would be set periodically by the PBGC board to ensure sufficient premium revenue to meet expected claims and pay off the current deficit over time.

This new risk-based premium would be based on more accurate funding targets and reflect the sponsor's financial condition, which would be an improvement over the current law.

To keep premiums to a reasonable level by reducing unreasonable risk, we would freeze the PBGC guarantee limit when a company enters bankruptcy, allow the PBGC to perfect liens for most required contributions, and prospectively eliminate the guarantee of shutdown benefits and prohibit such under-funded benefits in pension plans.

In conclusion, we are committed to working with Congress to ensure that there's meaningful defined benefit pension reforms enacted into law. We look forward to working with the Members of this Committee to achieve greater retirement security for the millions of American workers, retirees, and their families who depend on defined benefit plans.

Thank you very much, and we would all be happy to take questions.

[The prepared statement of Ms. Combs follows:]

**Statement of Ann L. Combs, Assistant Secretary of Labor, Employee Benefits Security Administration, U.S. Department of Labor, Washington, DC**

*Introductory Remarks*

Good morning Chairman Boehner, Ranking Member Miller, and members of the Committee. Thank you for inviting me to discuss the Administration's proposal to reform and strengthen the single-employer defined benefit pension system.

The Bush Administration believes that the pension promises companies have made to their workers and retirees must be kept. Single-employer, private sector defined benefit pension plans cover 16 percent of the nation's private workforce, or about 34 million Americans. The consequences of not honoring pension commitments are unacceptable—the retirement security of millions of current and future retirees is put at risk.

However, the current system does not ensure that pension plans are adequately funded. As a result, pension promises are too often broken.

Termination of plans without sufficient assets to pay promised benefits has a very real human cost. Many workers' and retirees' expectations are shattered, and, after a lifetime of work, they must change their retirement plans to reflect harsh, new realities. Underfunded plan terminations are also placing an increasing strain on the pension guaranty system.

Increased claims from terminations of significantly underfunded pension plans have resulted in a record deficit in the single-employer fund of the PBGC. For the fiscal year ending September 30, 2004, the PBGC reported a record deficit of $23.3 billion in that fund. The increasing PBGC deficit and high levels of plan underfunding are themselves a cause for concern. More importantly, they are symptomatic of serious structural problems in the private defined benefit system.

It is important to strengthen the financial health of the defined benefit plan system now. If significantly underfunded pension plans continue to terminate, not only will some workers lose benefits, but other plan sponsors, including those that are healthy and have funded their plans in a responsible manner, will be called on to pay far higher PBGC premiums. Underfunding in the pension system must be corrected now to protect worker benefits and to ensure taxpayers are not put at risk of being called on to pay for broken promises.

The Administration has developed a reform package to improve pension security for workers and retirees, stabilize the defined benefit system, and avoid a taxpayer bailout of PBGC. The President's proposal is based on three main elements:

First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises. The current system is ineffective and needlessly complex. The rules fail to ensure that many pension plans are and remain adequately funded.

Second, disclosure to workers, investors and regulators about pension plan status must be improved. Workers need to have good information about the funding status of their pension plans to make informed decisions about their retirement needs and financial futures. Too often in recent years, participants have mistakenly believed that their pension plans were well funded, only to receive a rude shock when the plan is terminated. Regulators and investors also require more timely and accurate information about the financial status of pension plans than is provided under current law.

Third, premium rates must be revised to more accurately reflect the risk of a plan defaulting on its promises and to help restore the PBGC to financial health. The current premium structure encourages irresponsible behavior by not reflecting a plan's true level of risk.

The proposal would strengthen the funding rules and defined benefit system, so that the nation's workers and retirees can be confident of the secure retirement they have worked for all their lives. I will now discuss the key provisions for each element of the President's proposal and the reasons these provisions are needed to protect the pensions of the 34 million Americans who are relying on the single-employer defined benefit pension promises made by their employers.

*Reforming the Funding Rules*

*The funding rules are complicated and ineffective.*

Current funding rules do not establish accurate funding targets and the lack of adequate consequences for underfunding a plan provides insufficient incentive for plans to become well funded. In addition, the funding rules fail to take into account the risk that a plan sponsor will fail.

Weaknesses in the current rules include, for example, multiple and inaccurate asset and liability measures and discount rates, smoothing mechanisms, credit balances that allow funding holidays to continue even as funding levels deteriorate, excessive discretion over actuarial assumptions, and varying and excessively lengthy amortization periods. As a result, companies can say their plans are fully funded when in fact they are substantially underfunded. Together these weaknesses allow companies to avoid making contributions when their plans are substantially underfunded. And in some circumstances, they actually prevent companies that want to increase funding of their pension plans from making additional contributions during good economic times.

These weaknesses contribute to the ability to manipulate funding targets which is of particular concern given the fact that they are set too low. There is no uniformity in liability measures under current law. In some cases, employers can stop making contributions when a plan is funded at 90 percent of "current liability." But current liability is not an accurate measure of pension funding requirements; even 100 percent of current liability is often far less than what will be owed if a plan is terminated. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants in the event of termination.

Why is current liability such a poor measure of true pension costs? One reason is that the interest rate used in determining current liability can be selected from an interest rate corridor that is based on an average of interest rates over the prior 48 months. As a result, during periods of rapidly changing interest rates, the current liability interest rate may bear little relationship to economic reality and misstate the risks to plan participants. Even if the current liability interest rate reflected current market conditions, it would produce an inaccurate measure of the plan's true liability because it is based on a long-term interest rate and fails to take into account the actual timing of when benefit payments will be due under the plan. That timing often is considerably sooner, especially for plans with a large number of older participants near retirement age.

Current liability also fails to account for the risk of plan termination. This is important because terminating plans incur additional costs not reflected in current liability. For example, when plans terminate, participants are more likely to draw benefits early and elect lump sums. Terminating plans must purchase insurance annuities at prices that reflect market interest rates and administrative expenses. These factors combine to escalate costs above those reflected in current liability, often by large amounts. While it is not necessary for all plans to fund to such a standard, in the case of a plan with a substantial risk of terminating, the pension funding target should take into account the additional costs of terminating the plan.

Another weakness in the funding rules is their reliance on the so-called "actuarial value" of plan assets. The actuarial value of plan assets may differ from the fair market value of plan assets. It may be determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of the plan. Using fair market value for purposes of the funding rules would give a clearer and more accurate picture of a plan's ability to pay promised benefits.

As an example of how all of this can affect workers and retirees, the U.S. Airways pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $1.5 billion shortfall. After believing their pensions were substantially secure, U.S. Airways pilots were shocked to learn how much of their promised benefits would be lost. Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion.

*The Bush Administration's Proposal*

The current funding rules must be strengthened to ensure that accrued benefits are adequately funded. This is particularly important for those plans at the greatest risk of terminating. The Administration's plan will bring simplicity, accuracy, stability, and flexibility to the funding rules, encouraging employers to fully fund their plans and ensuring that benefit promises are kept.

Under the President's proposal, the multiple sets of funding rules applicable to single-employer defined benefit plans would be replaced with a single set of rules. The rules would provide for each plan a single funding target that is based on meaningful, accurate measures of its liabilities that reflect the financial health of the employer and use fair market values of assets. Funding shortfalls would be amortized and paid over 7 years. Plan sponsors would have the opportunity to make additional, tax-deductible contributions in good years, even when the plan's assets are substantially above its funding target. In addition to the changes to the funding rules, new limits would be placed on unfunded benefit promises, reporting and disclosure of funding information would be improved, and PBGC premiums would be reformed to more fully reflect the risks and costs to the insurance program.

*Funding targets will depend on the plan sponsor's financial health.*

Pension liability computations should reflect the true present value of accrued future benefits—this is a key component of accuracy. Workers and retirees are interested in the present value of liabilities so that they can determine whether their plans and promised benefits are adequately funded. Plan sponsors and investors are interested in the present value of liabilities in order to determine the demands pension liabilities will place on the company's cash flows.

The Administration's proposal provides a single conceptual measure of liabilities based on benefits earned to date. Assumptions are modified as needed to reflect the financial health of the plan sponsor and the risk of termination posed by the plan. A plan's funding target would be the plan's ongoing, or alternatively, its at-risk liability, depending on the sponsor's financial health.

For a plan sponsor that is healthy, the funding target would be the plan's ongoing liability. The plan sponsor is considered financially healthy if any member of the plan sponsor's control group has senior unsecured debt rated as being investment grade (Baa or better). If a plan sponsor is financially weak, the funding target generally would be the plan's at-risk liability. A plan sponsor is considered financially weak if its senior unsecured debt is rated as below investment grade by every rating agency that rates the sponsor. A plan's funding target would phase up from ongoing to at-risk over a five-year period. Conversely, if a plan's credit rating is upgraded to investment grade, its funding target would immediately drop to ongoing liability.

Credit ratings are used to measure financial health because empirical evidence shows that a company's time spent in below investment grade status is a strong indicator of the likelihood of plan termination. It is also critical that a market-based test be used to establish financial health.

A plan's ongoing liability is equal to the present value of all benefits that the plan is expected to pay in the future, based on benefits earned through the beginning of the plan year. Workers are assumed to retire and to choose lump sums as others have in the past. A plan's at-risk liability is based on the same benefits, but assumes that employees will take lump sums and retire as soon as they can, and includes an additional amount reflective of the transaction cost of winding up a plan. These assumptions are designed to reflect behavior that typically occurs prior to plan termination when the financial health of the employer deteriorates.

The applicable funding target is calculated by discounting benefit liabilities based on a yield curve of long-term corporate bonds. The discount rate would reflect the duration of the liabilities. A plan's actuary would project the plan's cash flow in each future year and discount payments using the appropriate interest rate for the payment. In general, with a typical yield curve, plans with older workforces where payments are due sooner will discount a greater proportion of their liabilities with the lower interest rates from the short-end of the yield curve than plans with younger workforces where larger cash payments are delayed into the future. The corporate bond yield curve would be published by the Secretary of Treasury and would be based on the interest rates, averaged over 90 business days, for high quality corporate bonds rated AA, with varying maturities.

The use of a single conceptual measure of liabilities will simplify the funding rules. It will tell plan sponsors, investors, regulators, and most importantly, workers and retirees, whether a plan is adequately funded.

*Funding shortfalls should be made up over a reasonable period.*

Another problem with the current funding rules is that underfunded plans are permitted to make up their shortfalls over too long a period of time. In addition, underfunded plans are permitted funding holidays. These rules put workers at risk of having their plans terminate without adequate funding.

Under current law, if the unfunded accrued liability is attributable to a plan amendment, the amortization period for making up the shortfall is 30 years. Experience shows this is too long. There is too much risk that the plan will be terminated before 30 years has passed. Furthermore, collectively bargained plans often have a series of benefit increases every few years, which has the effect of increasing all of the liabilities accrued prior to the benefit increase as well as increasing future liabilities. As a result, these plans are perennially underfunded.

The credit balance rules for plan funding under current law also contribute to plan underfunding. The credit balance rules allow an employer to apply its contributions in excess of minimum requirements from an earlier year as an offset to the minimum funding requirement for a subsequent year without restrictions. This loophole allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market—and, more importantly, regardless of the current funded status of the plan. Credit balance rules harm the retirement security of workers and retirees. In the Bethlehem Steel and the U.S. Airways pilots' plan termination cases, for example, no contributions were made (or required to be made, as a result of credit balances) to either plan during the three or four years leading up to plan termination.

Under the Administration's proposal, plans would annually contribute enough to address their funding shortfall over a reasonable period of time, without funding holidays, until the shortfall is eliminated. Plan funding shortfalls would be amor-

tized over a 7-year period. The current law provision allowing an extension of amortization periods would no longer be available.

*Opportunity to increase funding in good years.*

We also must address the overly prescriptive funding rules for well-funded plans that discourage companies from building up a cushion to minimize contributions in lean years. To keep healthy companies in the defined benefit system, we need to give them better incentives.

The current funding rules can place a pension plan sponsor in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. This problem is caused by the interaction of the minimum funding requirements and the rules governing maximum deductible contributions. The rules restrict employers' ability to build up a cushion that could minimize the risk that contributions will have to be severely increased in poor economic times. This volatility in required contributions makes it difficult for plan sponsors to predict their funding obligations, and makes it difficult to prevent large required contributions during economic downturns when the company is least able to pay.

The Administration's proposal would permit plan sponsors to make additional deductible contributions up to a new higher maximum deductible amount. This would permit companies to increase funding during good economic times. Funding would be permitted on a tax-deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year, the applicable normal cost and a specified cushion. The cushion amount would enable plan sponsors to protect against funding volatility, and would be equal to 30 percent of the plan's funding target plus an amount to pre-fund projected salary increases (or projected benefit increases in a flat dollar plan). Plans would always be permitted to fund up to their at-risk liability target.

This cushion will help provide workers and retirees greater retirement security by increasing the assets available to finance retirement benefits.

*Limitations on plans funded below target levels.*

The current rules encourage some plans to be chronically underfunded, in part, because they shift potential losses to third parties. This is what economists refer to as a "moral hazard." Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in some situations, even make new benefit promises, while pushing the cost of paying for those benefits off into the future. For this reason, some companies have an incentive to provide generous pension benefits that they cannot currently finance, rather than increase wages. The company, its workers and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan, then by other plan sponsors in the form of PBGC guarantees. Under our proposed funding rules, financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they fund them in a reasonably timely manner.

If a company's plan is poorly funded, the company should be precluded from adopting further benefit increases unless it fully funds them, especially if it is in a weak financial position. If a plan is severely underfunded, retiring employees should not be able to elect lump sums and similar accelerated benefits. The payment of those benefits allows those participants to receive the full value of their benefits while depleting the plan assets for the remaining participants. A similar concern applies when a severely underfunded plan purchases annuities.

The Administration believes that we must ensure that companies, especially those in difficult financial straits, make only benefit promises they can afford, and take steps to fulfill their promises already made by appropriately funding their pension plans. In order to accomplish this goal, the proposal would place additional meaningful limitations on plans that are funded substantially below target levels.

First, the rules would limit benefit increases for certain underfunded plans. For a plan where the market value of the plan's assets is less than or equal to 80 percent of the funding target, no amendment increasing benefits would be permitted. If the market value of the plan's assets is above 80 percent of the funding target, but was less than 100 percent for the prior plan year, then no benefit increase amendment that would cause the market value of the plan's assets to be less than 80 percent of the funding target would be permitted. In either case, the sponsor could avoid the application of these limits by choosing to contribute the minimum required contribution and the increase in the funding target attributable to an amendment increasing benefits.

Second, the rules would limit lump sum distributions or other accelerated benefit distributions for certain underfunded plans. Limits would apply if either the market

value of a plan's assets is less than or equal to 60 percent of the funding target or the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 80 percent of the funding target.

Third, the rules would limit accruals for plans with severe funding shortfalls or sponsors in bankruptcy with assets less than the funding target. A plan is considered severely underfunded if the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 60 percent of the funding target. These plans pose great risk of plan termination and would effectively be required to be frozen.

Lastly, the rules would address an abuse recently seen in the airline industry—where executives of companies in financial difficulty have their nonqualified deferred compensation arrangements funded and made more secure, without addressing the risk to the retirement income of rank and file employees caused by severely underfunded pension plans. The rules would prohibit funding such executive compensation arrangements if a financially weak plan sponsor has a severely underfunded plan. Also, the rules would prohibit funding executive compensation arrangements less than 6 months before or 6 months after the termination of a plan where the plan assets are not sufficient to provide all benefits due under the plan. A plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition to recover the amount that was funded.

Plans that become subject to any of these benefit limitations would be required under ERISA to furnish a related notice to affected workers and retirees. In addition to letting workers know that limits have kicked in, this notice will alert workers when funding levels deteriorate and benefits already earned are in jeopardy.

*Improving Disclosure to Workers, Investors, and Regulators*

The financial health of defined benefit plans must be transparent and fully disclosed to the workers and their families who rely on promised benefits for a secure and dignified retirement. Investors and other stakeholders also need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

For example, the principal Federal source of information about private sector defined benefit plans is the Form 5500. Schedule B, the actuarial statement filed with the Form 5500, reports information on the plan's assets, liabilities and compliance with funding requirements. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, regulatory agencies are not notified of the plan's funded status for almost two years after the actual valuation date. If the market value of a plan's assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

The PBGC does receive more timely information regarding a limited number of underfunded plans that pose the greatest threat to the system under Section 4010 of ERISA. Section 4010 data provides identification, financial, and actuarial information about the plan. The financial information must include the company's audited financial statement. Sponsors also are required to provide actuarial information that includes the market value of their pension plan's assets, the value of the benefit liabilities on a termination basis, and a summary of the plan provisions for eligibility and benefits.

However, current law prohibits disclosure, so this information may not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan is vitally important to participants and investors. Making information regarding the financial condition of the pension plan publicly available would benefit investors and other stakeholders and is consistent with federal securities laws that Congress has strengthened to require the disclosure of information material to the financial condition of a publicly-traded company.

The most fundamental disclosure requirement of a pension's funding status to workers under current law is the summary annual report (SAR). The SAR discloses certain basic financial information from the Form 5500 including the pension plan's net asset value, expenses, income, contributions, and gains or losses. Pension plans are required to furnish a SAR to all covered workers and retirees within two months following the filing deadline of the Form 5500.

Information on a plan's funding target and a comparison of that liability to the market value of assets would provide more accurate disclosure of a plan's funded

status. Providing information on a more timely basis would further improve the usefulness of this information for workers and retirees.

*The Bush Administration's Proposal*

The Administration's proposal would allow information filed with the PBGC to be disclosable to the public and would provide for more timely and accurate disclosure of information to workers and retirees.

*Provide broader dissemination of plan information.*

Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, except for the information subject to Freedom of Information Act protections for corporate financial information, which includes confidential "trade secrets and commercial or financial information."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

*Provide more meaningful and timely information.*

The President's proposal would change the information required to be disclosed on the Form 5500 and SAR. Plans would be required to disclose the plan's ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year, or February 15 for a calendar year plan. If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

*Reforming Premiums to Better Reflect Plan Risk and Restoring the PBGC to Financial Health*

There are two fundamental problems with PBGC premiums. First, the premium structure does not meet basic insurance principles, including those that govern private-sector insurance plans. Second, the premiums do not raise sufficient revenue to meet expected claims. The single-employer program lacks risk-based underwriting standards. Plan sponsors face limited accountability regardless of the risk they impose on the system. As a result, there has been a tremendous amount of cost-shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

This excessive subsidization extends across industry sectors—to date, the steel and airline industries have accounted for more than 70 percent of PBGC's claims by dollar amount while covering less than 5 percent of the insured base.

The PBGC also needs better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs. Recent events have demonstrated that the agency's ability to protect the interests of beneficiaries and premium payers is extremely limited. This is especially true when a plan sponsor enters bankruptcy or provides plant shutdown benefits—benefits triggered by a plant closing or other condition that are generally not funded until the event occurs. Currently, the agency has few tools at its disposal other than to move to terminate plans in order to protect the program against further losses.

*The Bush Administration's Proposal*

The Administration's proposal would reform the PBGC's premium structure. The flat per-participant premium will be immediately adjusted to $30 initially to reflect the growth in worker wages since 1991, when the current $19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages

during this period, even as the premium was frozen. Going forward, the flat rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a risk-based premium will be charged based on the gap between a plan's funding target and its assets. Because the funding target takes account of the sponsor's financial condition, tying the risk based premium to the funding shortfall effectively adjusts the premium for both the degree of underfunding and the risk of termination. All underfunded plans would pay the risk based premium. The PBGC Board—which consists of the Secretaries of Labor, Treasury and Commerce—would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC's financial condition. Charging underfunded plans more gives employers an additional incentive to fully fund their pension promises.

As part of improving PBGC's financial condition, additional reforms are needed. Plan sponsor bankruptcies and plant shutdown benefits increase the probability of plan terminations and impose unreasonable costs on the PBGC. The proposal would freeze the PBGC guarantee limit when a company enters bankruptcy and allow the perfection of liens during bankruptcy by the PBGC for missed required pension contributions. The proposal also would prospectively eliminate the guarantee of certain unfunded contingent liability benefits, such as shutdown benefits, and prohibit such benefits under pension plans.

*Conclusion*

The Bush Administration is committed to working with Congress to ensure that the defined benefit pension reforms included with the President's Budget—strengthening the funding rules, improving disclosure, and reforming premiums—are enacted into law.

As I noted earlier, the primary goals of the Administration's proposal are to improve pension security for workers and retirees, to stabilize the defined benefit pension system, and to avoid a taxpayer bailout of the PBGC. This can be achieved by strengthening the financial integrity of the single-employer defined benefit system and making sure that pension promises made are promises kept. We look forward to working with Members of this Committee to achieve greater retirement security for the millions of Americans who depend on defined benefit plans.

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Chairman BOEHNER. I want to thank all three of you for coming today, and I congratulate the administration for their comprehensive proposal on single-employer defined benefit plan rules changes.

I think all of us know that over the last several decades, we've patched the system, we've plugged it, we've played with it, and the fact is it's time for a serious broad view of all of the rules, and I think the administration's proposal does that, not that I agree with every part of it.

Mr. Belt, the President's 2006 budget proposal provides for a complete elimination of the PBGC's deficit over the next 10 years, and since PBGC may not actually assume all those liabilities in the next 10 years, and quite frankly, will not assume all those liabilities in the next 10 years, is it appropriate to require a complete elimination of all of this debt over what I would call a relatively short period of time.

Mr. BELT. Mr. Chairman, that was, as you noted, the assumption used by OMB in its—in presenting the President's budget proposal.

I think it's important to understand that Congress has mandated that PBGC be self-financing by law, and our only source of revenues to cover expected claims is premiums.

Heretofore, that has been wholly inadequate. We've averaged historically about a billion dollars in premium revenue a year. That's both the flat rate and the variable rate premium.

But as I noted, our deficit position has swung by $30 billion in just the last 3 years, so obviously, that billion dollars is insufficient going forward. That's not a sustainable business model, as it were.

Then the question ultimately becomes, who pays for that?

The OMB used an assumption that that deficit would be amortized over a 10-year timeframe and would cover expected future claims.

If premiums aren't set at a level, like any insurance system is set, to have premiums cover expected future claims, then the question does become, and it's a policy question for Congress, who pays for those losses?

Chairman BOEHNER. The PBGC's deficit includes probable claims that the agency expects to assume in the future.

Can you tell me what the average time is for a probable claim before it becomes an actual claim on the PBGC?

Mr. BELT. It varies from year to year in economic cycle, but what I can tell you is, over time, 87 percent of claims that are booked as probable do become actual losses, and I would note that about half the companies that we booked as probable at the end of this last fiscal year have already come in as actual claims.

Chairman BOEHNER. The administration's funding proposal, as I look at it, could potentially cause an investment-grade company with lower credit ratings to be downgraded to below investment grade.

Do you share this concern, Mr. Warshawsky?

Mr. WARSHAWSKY. Mr. Chairman, we do not share that concern.

Our understanding is that the credit rating agencies currently have been focusing on the liabilities, the pension liabilities that companies have taken, that they have taken freely, and that are part of their cost of doing business, and although we believe that the calculation liability that we have put forward will more accurately represent the liability, it doesn't change the liability. The liability is there and the credit rating agencies are increasingly focusing on it.

So per se, we do not believe that will have an impact on the credit rating.

Mr. BELT. And under current law, Mr. Chairman, a number of companies, about 30 or 40, have actually been downgraded because of their under-funding in their pension plans.

I actually think it may work the other way, that the markets would reward companies for enhancing their funded status.

Chairman BOEHNER. Mr. Warshawsky, if we were to enact the administration's 2006 budget proposal to include a 50-plus percent increase in flat rate premiums, and do so in 1 year, in one jump, what do you think the reaction of employers would be? Terminate plans, freeze plans, begin the process of moving out of defined benefit plans?

Mr. WARSHAWSKY. I don't think so. These plans are—many plans are the result of collective bargaining agreements, and these plans represent benefits which are highly valued by employees, and rightfully so.

So I think employers will want to fund the benefits and I think the premium increase would not cause them to terminate the plan.

Mr. BELT. Mr. Chairman, if I might put it in perspective, for a company like United Airlines, which may present the PBGC with a $6 billion claim, they currently pay about $2 million a year in premiums. This would represent an increase of about a million dol-

lars a year in premium revenues, and I can tell you they're spending that much and more litigating against us each month in bankruptcy court, trying to avoid—trying to be able to put that $6 billion claim to the PBGC.

So it's actually a fairly modest increase relative to the liabilities and obligations that are out there.

Chairman BOEHNER. Ms. Combs, under the administration's proposal, the yield curve is used to determine lump sum distributions.

Can you explain to the Committee how this would work?

Ms. COMBS. Under current law, there's—as you know, the Congress last spring passed a substitute for the thirty-year Treasury over the long-term corporate bond, but there's now a disconnect between the rate that's applied to lump sums and the rate that's used for funding, and that actually creates an economic incentive for people to take lump sums and cash out of their plans.

We think the same rate should be applied for funding purposes, for all purposes—for funding, for calculating lump sums, for paying premiums.

Again, we believe it's an accurate measurement of what the liabilities are, and that people—it should be a neutral decision. The interest rate shouldn't determine whether you decide to take your benefit as a lump sum or as an annuity.

Chairman BOEHNER. My time has expired.

The Chair recognizes the gentleman from California, Mr. Miller.

Mr. MILLER. Thank you very much, Mr. Chairman.

In my opening statement, I mentioned that I have some concerns along some of the questions that you raised, Mr. Chairman, on the allocation of the variable rate and the impact on that, but I think I'd prefer to pursue that in writing, if we might.

I'd like to turn to another subject, and that subject is, Mr. Belt, in your statement, you talk about transparency, and you say that the funding and disclosure rules seem intended to obfuscate economic reality, and certainly their effect is to shield relevant information regarding the funding status of plans from participants, investors, and even regulators.

That sounds like a fairly successful obfuscation, if all three of those parties are not there, or don't have the transparency, and I'd like to ask a couple of questions about that.

First of all, it seems to me that in these companies, and the determinations on how they fund their pensions, there's apparently a whole litany of reasons why you would fund or not choose to fund your pension plans and when you would make that determination and what amount.

Some of it has to do with tax law, some of it has to do with the appearance of the corporate bottom line, some of it has to do with stock prices, some of it has to do with stock options, all of which can influence whether or not a company makes a decision.

But apparently, many of those decisions can be made, and the outcome in those decisions are hidden from the participants in the plan, the beneficiaries, if you will, and from the investing public, and apparently from the regulators for a considerable period of time.

Is that fairly accurate, Mr. Belt?

Mr. BELT. We are concerned, the administration is very concerned that not enough relevant, material, and timely information is provided to participants, who clearly need that information to make informed decisions about their own retirement security.

It's also true that not enough information is provided to the marketplace, to shareholders of companies, particularly publicly traded companies, whose impact on the company can be very substantial with respect to what's happening in the pension plan.

So the administration's proposal is to shed a little sunlight on the whole issue of pension funding so that all the various stakeholders have relevant, timely information so they can make these decisions on an informed basis, which isn't the case under current law, and that's a problem not only in ERISA, and we're addressing the ERISA portion of that, but there are also issues with respect to the accounting standards; and my understanding is the Financial Accounting Standards Board is looking at those issues, as well.

Mr. MILLER. Well, I'm encouraged that the administration has put forth these efforts to improve the transparency.

We're telling the American worker and American families that they have to take more and more control over their retirement security, and the knowledge of the jeopardy of the retirement plan that you're currently included in may have a great deal of influence on decisions that you would make as a family.

You may want to continue to work for that employer, even though that plan looks like it's in jeopardy, but you also may want to increase your private savings or you may want to think about other changes that your family can make.

And what you have now is, you clearly have a conspiracy to keep the beneficiaries of this plan from having that information.

If you're an investor in these companies, you may want to know what their real obligations are, not the obligations they gave up for the appearances of changing the bottom line or changing the exercise of stock options, but what the real impact is on the financial liabilities of this company, and investors are entitled to that.

In the situation that you describe in these three pages is really one that we've now found unacceptable in every other part of the business world. That's why Mr. Spitzer is hauling people into court, because we have all of these secret arrangements that keep one interested party from the apparent conflicts of the other, and we want transparency on that.

In this situation, you're playing with people's life savings, and in many instances, you're playing with people's life savings who have very little, very few options to change them, because they find out about it, as you point out, a great number of them are quite surprised when they find out when they're in trustee—the plans that you say you're a trustee for, they're quite surprised to learn that the plans were under-funded at all. That's the first notice they had of it.

So I mean, I welcome this, and I hope that these are strong enough. I suspect that they'll probably be resisted, but certainly it's the minimum that the investors are entitled to and that the plan participants are entitled to.

I always find it rather interesting before some of these companies rush to bankruptcy, the first thing they do is ensure the pensions

and the deferred compensation of their CEOs and their top-line executives, so that they're outside of bankruptcy.

So they obviously have notice that things are not on the up side here, because they rush out and buy an insurance policy for their golden parachutes.

Well, most employees will not be able to do that. The least we can do is give them notice of what the actual real and real-time situation is with respect to their employer's financial liabilities, the health of that company, and the health of their pension plan so that they can make some determinations.

And the marketplace is, in fact, a partner with these pension plans, and it should be a partner with these pension plans, and there's a certain sanitizing of that, but if this information can even be held from the marketplace, then it's not working.

And so I want to thank the administration for spotlighting those areas that I think are terribly important to a well-functioning pension security plan, and I plan to pursue this further both with the administration and with my colleagues in Congress.

Thank you.

Mr. JOHNSON [presiding]. You know, it's not often I agree with—

[Laughter.]

Mr. MILLER. You go far enough right, and you'll meet the guy from the left coming around the other side.

[Laughter.]

Mr. MILLER. It's a round world, remember.

Mr. JOHNSON. Thank God, huh? We'd fall off.

You know, there's much to commend the administration in coming forward with their proposals, and I applaud the general approach on moving to risk-based governance of pension plans. It works pretty well for car insurance, it ought to work better for pension plans than what we've been using.

That said, I have some questions.

At the joint pension hearings that we held last year between my Subcommittee and the Ways and Means Subcommittee on Select Revenues, I had talked with you, Ann Combs, about the multi-employer pension plan reforms, and you assured me that to the extent we were going to increase disclosure and funding rules on single employer plans, we'd also work on similar reforms on multi-employer plans.

Unfortunately, your proposal contains only single-employer reforms. Multi-employer plans have never had a premium increase. There are some real problems in that area. And yet the administration has made no recommendations regarding these.

How long were you planning to wait before making suggestions in that arena, and will you follow through on your assurance that you would work with us to achieve similar reforms in the multi-employer plans?

Ms. COMBS. We are concerned about multi-employer plans as well, and the workers who participate in them, and our judgment was, in putting this package together, that the problems facing the single-employer system are simply much larger in nominal dollar terms and the problems are more acute.

Workers' benefits in single-employer plans are actually more at risk than they are in the multi-employer system because of the way it works.

That being said, there are major problems there, and we do want to work with Congress and with you, Mr. Johnson, to address them, and I think we've talked to your staff and others, and I think been up front about the fact that we wanted to get the single-employer proposal out into the public space and begin to debate it. We thought it was important that it not be held up while we try to figure out how we should deal with the problems facing multis.

They're very different systems. I think they need different solutions. And we have begun to think about that internally. We want to sit down with you, and we hear the message that the Committee wants to address it as part of this bill, and we will work with you on that, but we wanted to get this out and in the debate, out of the way—

Mr. JOHNSON. Well, but as Mr. Miller points out, disclosure is the same for both plans, and I don't understand why we can't at least do that much.

You know, it's the same for multi-employer as it is for single employer.

Ms. COMBS. I think that's true, and I would just note that you did include some disclosure for multis in the bill that you passed last spring, and we have issued proposed regulations to put that into effect.

We are very committed to transparency and disclosure, and we will work with that.

Mr. JOHNSON. I appreciate that. Thank you for your response.

Mr. Belt, you all took over U.S. Air, and I'm wondering, are you going to do the same thing with United? Because I think that was a terrible disservice to the airline industry, because now U.S. Air can set their prices wherever in the heck they want to without having to worry about funding a pension plan.

Furthermore, the pilots, as you know, receive less, because of the retirement system the way it's set up, and can you address that issue.

And are you going to stand firm with United?

Mr. BELT. I would be pleased to do so, Mr. Chairman.

As you know, that's not a decision that's actually made by the PBGC.

Mr. JOHNSON. Who makes it?

Mr. BELT. The bankruptcy court judge. Under law, under ERISA, companies are able to file what is known as a distress termination application to the bankruptcy court once they're in Chapter 11.

It is the bankruptcy court that makes the decision as to whether or not the company would be able to successfully emerge from Chapter 11 and still maintain its pension plans.

In many cases—in the case of U.S. Airways, and of course in the case of United—they made it very clear their view is they have to shed those pension liabilities onto the pension insurance program in order to successfully emerge.

We do not actually make the decision, but we certainly engage with the company and with the bankruptcy court.

In the case of U.S. Airways, we concluded, on a good faith basis, that they met the criteria under the law to turn their pension plans over to the Pension Benefit Guaranty Corporation, the criteria established by Congress.

We have not yet reached that decision with respect to United Airlines. We've publicly indicated that based upon information that was available a couple of months ago that they in fact could not afford all four of their pension plans, but our view was they could afford at least two, perhaps three, but of course the situation is very much in flux depending on what happens in the market, depending on what happens with fuel prices.

Mr. JOHNSON. OK. I think that you've given them an advantage by doing that, and perhaps we ought to see if we can't get you involved in the bankruptcy court. Of course, that's a different Committee. But somehow you should have more of an input.

And, you know, as an independent agency, which you are, it seems to me that you ought to be protecting the dollars of the citizens and not necessarily doing everything the bankruptcy court tells you to do. I understand you're under some constraints there.

But thank you for your comments.

Mr. Kucinich, you're recognized for 5 minutes.

Mr. KUCINICH. Thank you very much, Mr. Chairman, Ranking Member Miller, and Members of the Committee.

The appropriate title of this meeting is "The Retirement Security Crisis," and I think, as some members have stated before, we need to look at this in the context of the American workers' dilemma where their retirement security depends not only on Social Security, which I believe, you know, the administration's plan is effectively being dismissed by the American people, but also on savings.

And you have to keep in mind that savings, right now the average savings for a worker about 55 years old is about $10,400, and there has been a decline in seven consecutive quarters in terms of average savings. It's the first such decline since 1934.

And to that you add the fact that's been produced today, that the average pension funding level has declined from 120 percent to approximately 80 percent—now it's going back up to 85—we really need to talk about the retirement security crisis in its totality.

Now, in my own district—and I want to address these remarks specifically to Ms. Combs—a group of 19 employees saw their retirement funds vanish as their employer, the Lakewood Manufacturing Company, repeatedly dismissed employee requests for the release of plan documents, for over 5 years.

And for a period of over 5 years, the plan's fiduciary, who also happened to be the owner of the company, used funds from the employee pension plan to make dangerous and imprudent investments in companies in which he had a personal stake.

During this time, the fiduciary failed to file a Form 5500 for three consecutive years.

Only after thorough research by my office, and based on employee complaints, did the Department of Labor finally investigate the plan in late 2001, but by then the damage was done. The company's most recent 5500 filing in 1998 reported pension investments totaling over 1.9 million and by 2001, all of the money was gone; and had the fact that Lakewood did not file the required 5500

form in 1999 been flagged by the DOL, most of the workers' retirement money might have been saved.

So I'm glad to hear that the Department of Labor agrees that it's necessary to shorten the time plans are given to file 5500 forms. I'm concerned that this new due date would not include plans with less than 100 participants.

And, you know, we're all here advocates of small business, but we also ought to be advocates of employees of small businesses, and with plans with less than 100 participants not being covered, there's a question here.

Further, I'm concerned that the benefits of this improvement in filing time will be lost by inaction on the part of the Department of Labor when companies fail to file at all.

So, you know, I would contend, and I'd be happy to hear your response in a moment, that the practice of filing the 5500 form suffers from serious inefficiencies. Why should workers in smaller plans and companies be excluded from the protections that 5500 forms are supposed to offer, and a company that intentionally fails to file at all faces no consequences, at least with respect to labor.

How effective can the Department of Labor be in protecting employee pension assets with such lax reporting requirements, and if a 5500 is not filed, you know, what authority does the Department of Labor have now to compel filing, such as freezing the assets of a plan fiduciary until the form is submitted?

And I'd be very appreciative of hearing whether or not you're going to come to Congress for that authority and what you're prepared to do to protect those millions of Americans who work in companies that are smaller than 100 employees.

Ms. COMBS. Right. You raise some very important issues.

The proposal to exclude plans with fewer than 100 participants is from the requirement to file the accelerated actuarial information only, that's the carve-out, and that was a balance we tried to strike because of the burden it can place on small plans to have to do estimated actuarial valuations in advance.

Small plans do have to file the 5500. There's not a carve-out for them. And we do have the authority to impose civil penalties on people who either file late or who don't file at all.

I will tell you it is difficult to find people who never file at all. We do have a system in place where if people stop filing, we go and we check and see why they stopped filing, and often the plan may be terminated or there may be a reason. But if someone never starts to file, it's hard to get them on our radar screen.

We do have now a new position throughout the country. We have what are called benefit advisors. We have 110 folks around the country who—and we're trying to advertise our 800 number, essentially our toll-free number, to get people to call us and tell us when they see discrepancies.

That's the best source we have for investigations to go in and see if there's a problem, and I'm sorry it took so long for us to become aware of this problem.

We've also been doing an outreach with congressional offices, because we know people often call their Member of Congress, and so we want to make your offices aware of our services, as well.

But we do have an enforcement program that focuses on the filing of the 5500. We do impose substantial civil penalties, up to $1,000 a day, for the failure to file or for filing late or incomplete 5500's, and we have an office of chief accountant who has a program to enforce that, and we'll be happy to come explain it, and if it needs to be—if you'd like to talk about additional remedies, we'd be happy to talk to you about them.

Chairman BOEHNER. The gentleman's time has expired.

Mr. KUCINICH. But what I don't understand, if the gentlelady is saying that this new date is going to include plans for those with less than 100 participants?

Ms. COMBS. Plans with less than 100 participants do have to file a 5500, and our proposal does not change that.

What we have said is, plans that have more than 100 now have to file the Schedule B, which is the actuarial information that's attached to the form earlier, much earlier, but the small plans we did carve out because of the administrative burden in trying to balance that cost-benefit analysis.

Mr. KUCINICH. That's what we need to talk about, Mr. Chairman. Thank you.

Ms. COMBS. OK.

Chairman BOEHNER. The Chair recognizes the gentleman from Minnesota, Mr. Kline.

Mr. KLINE. Thank you, Mr. Chairman.

I thank the witnesses for being here today and I'll add my apologies to those, I'm sure, of many of my colleagues. As we're moving back and forth between hearings sometimes we miss a piece of your testimony or the answer to a question, so I may cover some familiar ground—familiar to you, but not necessarily to me.

I want to identify myself with the remarks of Mr. Johnson about the multi-employer plans, Ms. Combs. I understand that in terms of total dollars, if you will, that it's not the same magnitude, and yet we know we've had testimony in hearings in this Committee that there are multi-employer plans—Central States comes to mind right away—that are facing some serious problems, and I think we do need to address those, and I hope that my colleagues and I will address it as we move forward to address the retirement security crisis.

I wish that the administration had included that.

I also way to identify myself with his remarks, Mr. Johnson's remarks, about the airlines.

We had—by U.S. Airways going into bankruptcy, it's gained a competitive advantage with other airlines, and not a secret to those of you who have maps and see where airlines are headquartered, I've got the headquarters of a large airline, Northwest Airlines, in my district, and I'm very concerned that at the end of the day, when we move forward to take action on the administration's proposal and our proposal, that we have a policy that protects the retirement benefits of the retirees, provides some protection for the PBGC, Mr. Belt, but also doesn't force other companies into bankruptcy, and I'm not sure that we're there yet with the administration's proposal and the legislation as it moves forward.

We've made some changes in the President's proposal with interest rates, talking about yield curve instead of Treasury, and there's an issue of smoothing.

I wonder, I don't know if—Mr. Warshawsky, I think this is in you our particular bailiwick.

Could you, just for my understanding, explain what would happen if short-term interest rates rise and long-term rates fall, what are the consequences for employers with respect to how much they would have to contribute? What effect would that have?

Mr. WARSHAWSKY. Well, first let me say, and actually in a way it's—I want to respond to something that Mr. Miller said, that the point of the yield curve and the other reforms in terms of the measurement of pension liability is to get a timely and accurate—accurate in the sense of current—measure of the plan's funding status. That's what is, what really is appropriate for the funding target; that's what is appropriate for the plan participants to know, and that is the goal of our reform.

Congressman, with regard to your specific question about the shape of the yield curve, it is very rare to have what I would say you're referring to, which is an inverted yield curve, where short rates are higher than long rates.

That's a very rare occurrence, particularly in the corporate market. It occasionally occurs in the Treasury market, is an extremely rare occurrence in the corporate bond market.

Mr. KLINE. So we can disregard it?

Mr. WARSHAWSKY. I think largely it can be disregarded.

Mr. KLINE. Unless it happens, of course.

[Laughter.]

Mr. WARSHAWSKY. We only have the historical record to work with.

Mr. KLINE. Yes, sir, I understand.

Could we talk about the smoothing issue? I understand in the administration's proposal that you're talking about smoothing over 90 days, which is a quarter. Why is this more accurate, and why is this better, and why does this work better for planning purposes for those who are maintaining these plans?

Mr. WARSHAWSKY. Clearly, this is—I think we've used the term "a balance," and there's a balance here as well.

One could go to the end of the spectrum, where you basically have the plan measured on a date, December 31st of the end of the year.

We felt as if there is some noise in bond markets and interest rates, which generally, experience seems to indicate that takes a month or two to work out, and therefore we choose—chose a 90-day smoothing mechanism, actually, it's 90 business days, so it's actually more like four-and-a-half months, to account for noise.

Beyond that, however, we felt as if we really lose to much in the way of the accuracy, which we all agree is very important for all the purposes, and we didn't want to have more smoothing, which basically is masking the true status of the plan.

Mr. KLINE. Thank you.

Mr. Chairman, I see my time has expired, and I yield back.

Chairman BOEHNER. The Chair recognizes the gentleman from Virginia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman, and I apologize that I had to leave, so some of these questions may have already been addressed.

Mr. Belt, you indicated that some of the firms are having difficulty with their pension funds because they're in financial difficulty; is that accurate?

Mr. BELT. It is—PBGC as an insurer becomes most concerned when you combine under-funding with credit default risk, and so most of our attention is focusing on those cases where companies that are in financial difficulty are sponsoring plans that are well under-funded.

Mr. SCOTT. Now, is the fund a separate fund? I mean, if the company goes bankrupt, what happens to its pension fund money?

Mr. BELT. Well, Ann could talk about that. It's a separate legal entity.

When we trustee, when we take over a pension plan when it terminates in under-funded status, we actually get the assets of that pension plan as well as all the liabilities.

Unfortunately, whenever we take over an under-funded plan ,there are many more liabilities than there are assets.

Mr. SCOTT. Now, this is a trust fund, and the fiduciaries have a fiduciary responsibility, so they can't dip into the fund for anything other than paying out benefits; is that right?

Ms. COMBS. That's correct.

Mr. SCOTT. And if they do dip into it for something else, has a crime been committed?

Ms. COMBS. I'm sorry? There's a violation of the law. It's a fiduciary responsibility to not use it for anything other than to pay benefits and reasonable expenses.

Mr. SCOTT. And if people are dipping into it, I mean, are they prosecuted?

Ms. COMBS. Yes, they are. We had over 4,000 cases last year, civil and criminal.

Mr. SCOTT. Now, to determine whether or not the thing is solvent or not, what rate of return do you assume to determine whether or not a plan is solvent?

Mr. BELT. The issue is not whether it's solvent as such. The question is whether the pension plan is terminated for any of a variety of reasons.

We discussed earlier the situation that arises, for example, in the airline situations, where they're seeking to terminate their pension plan, saying that they cannot afford them and stay in business.

The decision then becomes how do you value those liabilities when the pension plan is terminated? And we use a market-based mechanism, what private insurers would charge to do annuities for somebody who did a standard termination of a fully funded plan.

Mr. SCOTT. And if you look and find that it is under-funded because the stock market went down or something like that, then what action is taken?

Mr. BELT. Well, as I indicated, we have—we take over the assets in that pension plan, but there's a big gap there.

The company is notionally liable for all of the difference under law. However, our historical experience in trying to recover on our

claim in bankruptcy has been that we get about seven cents on the dollar.

Mr. SCOTT. How did it get so under-funded, I mean, if people are watching?

Mr. BELT. That's an excellent question, and a variety of factors have caused pension plans in many cases to get under-funded.

Much of what we've been talking about has been mechanisms in current law that really have enabled this to happen. It was a combination of marketplace factors.

There were some falling asset prices between 1999 and 2003. Interest rates were coming down, which caused an increase in the value of the liabilities.

At the same time, because companies had put in extra monies in their earlier years, they were able to take advantage of contribution holidays, credit balances, so that in fact, at the same time that asset prices were falling and interest rates were falling and the liability was widening, they were putting no money into the pension plan.

They continued to have to pay out benefits, which further drained assets. Liabilities continued to accrue. So the gap widened and widened and widened.

A recent study by Credit Suisse First Boston noted that between 1999 and 2003, for the system as a whole, for the S&P 500, assets grew by a total of $10 billion, less than 1 percent per year compound annual growth rate, while liabilities grew by $430 billion during that period of time, a 10 percent annual compound growth rate.

Mr. SCOTT. OK. Now, you said all this started in 1999 to 2003. How about around 2000 or 2001? Didn't somebody notice that more contributions needed to go in?

Mr. BELT. Well, that's where we get into the issues of credit balance and smoothing.

The current system unfortunately hides what's happening in the pension plan, and there were a couple of charts in my testimony, in my written testimony, showing examples with a couple plans we've taken over, U.S. Airways and Bethlehem Steel, that noted that on a current liability basis, they were telling us, they were telling participants that they were 90-plus percent funded, while on a termination basis, which became more and more relevant as their financial condition deteriorated, they were perhaps only 50 percent funded, and they were not required to pay any variable rate premium, they were not required to pay—to provide a notice to participants regarding their funded status, and in many cases, they were not making any contributions to the pension plan.

Mr. SCOTT. Mr. Chairman, let me just ask one quick—were they telling the truth?

Mr. BELT. They were fully complying with current law, which is part of the problem.

Chairman BOEHNER. The Chair recognizes the gentleman from Georgia, Mr. Price, for 5 minutes.

Mr. PRICE. Thank you, Mr. Chairman.

I do appreciate the testimony, and I also appreciate the administration's desire to address what I think is a huge, looming problem, and I hear from some of my constituents to that effect, as well.

I'd like to step back, though, a little bit and kind of follow up on what Mr. Scott was talking about, and try to understand how we got to where we are right now.

It looks like the folks that ought to be minding the store weren't minding the store, and I guess I need—I want to step back and get a perspective from each of you, if you have thoughts about it, kind of following up on where Mr. Belt was, about how we ended up—how did we get to this point right here? What's the fundamental problem that resulted in where we are?

Ms. COMBS. Well, I think as Mr. Belt described, I mean, the recent combination of market forces has put a spotlight on the problem, but the underlying problem is that the current rules, the funding rules that we're talking about changing, are inadequate.

They don't require companies to put enough money in on an ongoing basis to meet the obligations that they have. They allow the companies to continue to make benefit promises when they're at a point when they're very under-funded and they shouldn't be making additional promises, they haven't funded the ones that they've already made.

The disclosure is weak, so that people are slow to see the problem developing and they're unaware that it's beginning to brew in their plans.

And so that is why we've come up with a comprehensive proposal, and I agree with the Chairman and the principles he laid out last year, that this is not a matter of tinkering. The system is fundamentally broken, and we need to go in and we need to fix the rules that govern how much money has to be set aside, the rules that govern how that is communicated to workers, retirees, people in the marketplace, and we need to tell people that if they get into a position because of market forces where their plans are severely under-funded, and particularly when the company sponsoring it is financially weak and has other demands, that they need to stop making additional benefit promises.

So we think our proposal addresses it.

I'd say the current market situation has really just put a spotlight on the fact that the rules are too weak.

Mr. PRICE. You believe that the recommendations from the administration address across the board the problems that resulted in where we are right now?

Ms. COMBS. Yes, I do.

Mr. WARSHAWSKY. Congressman, if I might add, from a bit of a historical perspective and even a personal perspective, I used to work at the Internal Revenue Service, more than 10 years ago, in the employee plans division, and the IRS, along with the Department of Labor, is responsible for enforcing the minimum funding requirements.

And when I was there, we did an examination program to be sure that plan sponsors were following the law, because it could be that the problem was that they weren't following the law, and that was the source of the problem then, which was more than 10 years ago.

Our examination and study indicated that the problem largely was not a problem of compliance with the law, but it was a prob-

lem with the law itself, and we believe the same is true now, and therefore we have put forward our proposal.

Mr. PRICE. Thank you.

Mr. Belt, I want to ask you a specific question, though.

You mentioned in response to a previous question that the current system hides the health status, if you will, of a plan.

Do you believe that this corrects that, the ability to hide that status?

Mr. WARSHAWSKY. We believe very strongly that it does.

And the current system hides the health status of the plan both on the asset side and on the liability side.

Current law allows something called actuarial value, which is again a smoothing mechanism for the value of assets which could—there could be as much as a 20 percent difference in the value between actuarial value and market value, and then it certainly does on the liability side, as well.

We believe that our proposal will give a much, much clearer and accurate measure on both the asset and liability side.

Mr. PRICE. Let me follow up on another question that was asked earlier about the bankruptcy court being the ones that determine whether or not y'all have to take over the plan.

Is there a problem there that needs to be addressed, as well?

Mr. BELT. That's obviously a policy decision that Congress would need to make.

Mr. PRICE. Do you believe there's a problem there that needs to be addressed?

Mr. BELT. All I can say, Congressman, is what happens under current law is that the bankruptcy court makes its decision. The bankruptcy court's judges' interests are aligned typically with the debtor, the company, because they're trying to get the company to emerge successfully.

The bankruptcy judge makes that determination on affordability. We provide information to the bankruptcy court regarding our analysis of whether they've met the distress criteria.

The bankruptcy court can choose to accept our analysis or not. He may agree with our analysis. He may agree with the company's analysis.

Our experience has been that we don't do very well in bankruptcy court.

Mr. PRICE. Thank you.

Thank you, Mr. Chairman.

Chairman BOEHNER. The Chair recognizes the gentleman from New Jersey, Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

I thank the witnesses for their testimony and I apologize for not being personally present when you gave your testimony, but I did have a chance to read it, and I appreciate what you've done.

I think we share a healthy bias, and that bias is in favor of the retention and growth of defined benefit plans. I think it's good for the economy. I think it's good for the individuals who participate, good for the employers.

I also think that the most effective means to solve the PBGC crisis is to make sure we still have plenty of premium payers, meaning plenty of people sponsoring defined benefit plans.

I personally also share your proposal that in good times we should lift the artificially low contribution limits that exist, I think solely for revenue reasons, and I think when good times occur, that we should encourage employers to put more away and make those contributions fully deductible.

It is with that concept in mind that I do have some concerns about the yield curve proposal with respect to the interest rates.

I think that your inclination to simplify interest rates by having one interest rate apply to all calculations is conceptually a good one, but I do have a real concern about the complexity we're adding to the system through the yield curve calculation.

I think that the litmus test that we should apply for any of these proposed changes is whether they make the retention and growth of defined benefit plans more likely or less likely.

I think it is a general rule of thumb that uncertainty makes these plans less likely. Corporate decisionmakers living in an extremely volatile world, where they are judged each quarter, maybe even each week by their financial performance, make these decisionmakers reject uncertainty. The more uncertain something is, the less likely they're going to do it; and there's a massive uncertainty, I think, built into an interest rate calculation that depends upon variable factors.

Your approach is theoretically elegant, because it does measure how many people are going to be receiving benefits how soon, and that is a more precise and elegant measure of what we want to do, but I think that that measure has negative consequences for corporate decisionmakers.

For example, if I were a CEO and I decided to try to pare my workforce by encouraging an early retirement plan where I gave early retirement bonuses in a big hurry. That has profound consequences for my retirement fund and it also has profound consequences for my future workforce. Merger and acquisition decisions, spinoff decisions are affected by this.

The premise that one's workforce is relatively constant in age and in liberality of benefit I think is not correct. I think that the age of your workforce changes as you implement these strategies, and the liberality of your benefit may change as you have different business units handling different employees.

So I'm not prepared this morning to say that I think the yield curve is a terrible idea and we shouldn't do it, but tell me why it doesn't add more uncertainty to a corporate decisionmaker's look at a DB plan.

Tell me why a corporate decisionmaker isn't going to look at this and say, "Oh, my goodness. Here's one more set of variables that I cannot control that make this defined benefit plan too unwieldy, too much of a risk, and let's just kick it all over to a defined contribution plan and get out of this."

Why is that not true?

Mr. WARSHAWSKY. Congressman, I'll mention a few things, but probably the most important item is that we believe that our proposal, taken as a whole—and the yield curve is just part of it, it's an important part, but it really has to be viewed in the context of the whole proposal—is that we actually are providing tools to plan sponsors to manage that uncertainty and those risks.

I think you have indicated that the ability to advance fund, prefund in good times is a very important aspect of the proposal that enables plan sponsors to manage that risk and manage that uncertainty.

Also, our 7-year amortization is a liberalization of current law compared to periods which are as short as 4 years under current law.

And it also is within the plan sponsor's purview, and it's a matter of its risk tolerance as to the asset allocation that it would want to choose.

I would also indicate that we appreciate the comment that it's elegant. We think it's elegant, as well. But clearly, this is—

Mr. ANDREWS. I meant that in a technical sense, the way Alan Greenspan means "elegant."

[Laughter.]

Mr. ANDREWS. Because, you know, you can dress a pig up, and it still is a pig.

Mr. WARSHAWSKY. I would say that, but at the same time, this is a practical proposal, because yield curves are very commonly used in a lot of other applications in finance and corporations and in mortgages, even in common banking procedures in terms of different rates for different maturities of certificates of deposit.

We think that this is actually a very, not a burdensome calculation at all. It can be done on a spreadsheet.

Mr. ANDREWS. I appreciate that. I see my time is up.

I would just add, though, that my concern is that, by necessity, corporate decisionmakers must change the shape and age of their workforce constantly, and as that changes, so do the underlying factors in the formula, which means so does the formula, which means so do your obligations, which gives you more volatility. That's my concern.

Thank you.

Chairman BOEHNER. The Chair recognizes the gentleman from New Jersey.

Ms. Combs, would you like to comment?

Ms. COMBS. No. I'm just looking for the gentleman from New Jersey.

[Laughter.]

Chairman BOEHNER. The Chair recognizes the gentleman from New Jersey, Mr. Holt, for 5 minutes.

Mr. HOLT. As the other gentleman from New Jersey, I would like to associate myself with the comments and questions of the gentleman from New Jersey behind me, and also with the questions from the gentleman from Ohio about why smaller companies—employees at smaller companies shouldn't have the same guarantee.

I just wanted to deal with one aspect of this, which has to do with the tax benefits that come to an employer, and I want to make sure that, as we encourage better planning for better funding, we're not allowing companies to use the funds for other purposes, for unrelated purposes.

And I just wanted to probe the witnesses to get your idea of why you think what's written in here provides adequate protection.

Ms. Combs, you've made it clear, with more than 4,000 prosecutions, civil and criminal, a year, you take it seriously and you let

employers know that you take seriously any misuse of funds, but there are a number of clever—yes, even elegant—ways that corporations have found to use these funds that's not actually criminal, but it seems to be for purposes other than maintaining the viability of people's retirement.

So I'd like to hear you elaborate on some of what you've said already about why you think the protections for devoting funds to unrelated purposes are good enough.

Ms. COMBS. The law is pretty absolute. The funds that are set aside and held in trust, they have to be segregated from the corporate assets and held in a separate legal trust, are there solely for the benefit of the workers and the retirees in that plan.

Mr. HOLT. Let me just say, though, part of what I think makes it possible for them to do this are the tax deductions they get for the larger plan contributions and so forth.

Ms. COMBS. There were situations back in the 1980's where companies were terminating plans and taking out excess assets and then reestablishing them. That has been effectively eliminated. There is now a 50 percent excise tax on any excess assets that are recovered from a terminated plan that has more than enough assets to meet its obligations, so that is—that no longer occurs.

There are rules against using the plan assets for the interest of the employer, the so-called prohibited transaction rules. You cannot use the assets for the benefit of the employer or deal with it in a self-dealing fashion.

The only real exception to being able to use excess assets for another purpose is in the tax code, which is if a plan is more than 125 percent funded, it can use, take out assets to pay for retiree medical benefits, but only enough to pay for the retiree medical benefits that are owed that year.

That is really the only exception. It's very limited, and the law is strictly enforced, as you said.

Mr. HOLT. Would either of the other witnesses care to comment?

[No response.]

Mr. HOLT. All right. I yield back my time.

Chairman BOEHNER. Would the gentleman yield?

Mr. HOLT. Yes, of course.

Chairman BOEHNER. I think Ms. Combs has adequately explained assets that go into a defined benefit pension system are, in fact, I think adequately protected.

The problem we have under the current rules is are there situations where, because they have credit balances that—and they can use assets in their plan, they don't have to mark those to the market, that people can avoid payments at times, payments that should have gone into these pension systems?

And if you look at the, we'll take the Bethlehem Steel case as an example, where in terms of the model, the rules that we have, it looked like they were in decent shape, but when you took away the credit balances, when you marked their assets and liabilities to what were real in the marketplace, they weren't anywhere close to being funded.

And it's those rules about how we're going to view the assets, those rules about how we're going to deal with credit balances, and what the effective discount rate should be that will prevent plan

sponsors from getting themselves in any more serious trouble than some have already done.

Mr. HOLT. Yes, Mr. Chairman, and I just want to make sure that as we put in place methods to encourage companies to fully fund these plans and keep them up, that we're not rewarding diversion of funds for other purposes, so that it really will be used to ensure the financial stability and security of the plans.

So thank you very much, Mr. Chairman.

Chairman BOEHNER. The Chair recognizes the gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

In the administration's proposal, companies with at-risk plans that fund their plans at 40 percent or below cannot increase benefits or credit future accruals to employees, and I think I agree with this, but why is this not extended to the company executives?

Ms. COMBS. That is the situation where we would say if a company is financially weak and their plan is less than 60 percent funded, the plan would be frozen and the non-qualified executive compensation could also not be secured. They could not use corporate assets to fund their own executive compensation.

If they did, the pension plan would have a right of action to recover that money and have it put into the pension plan.

So we have proposed kind of the what's good for the top floor is good for the shop floor rule.

Mrs. BIGGERT. OK. Then why do you think that Congress's role of setting risk-based premiums should be transferred to the PBGC board?

You know, we hate to lose power, I guess.

[Laughter.]

Mr. BELT. Well, it comes back to a point I had made earlier, that in any financially viable insurance system, premiums need to be set at a level and periodically adjusted to be able to cover expected claims. That has not been the case in the pension insurance program.

Congress did set the level of premiums, but the last time they did so was in 1994, eleven years ago, and premiums have not adjusted since then, notwithstanding the fact that we've had substantially greater period of claims, higher claims over the last few years.

So again, as I noted earlier, historically, we've derived about a billion dollars a year in premium revenue. Yet, just over the last 3 years, our net position has deteriorated by $30 billion.

So obviously, there's a disconnect in what premium levels have been and it's an unusual premium environment where premium payers are able to go for 14 years without any premium increase. I wish I could say the same thing about my homeowner's insurance or health-care insurance and anything else.

And so that's the reason to give the flexibility to the PBGC board, which is in the best position to respond appropriately to marketplace developments, and I would note that the FDIC, another Federal insurer, has similar type of premium setting authority.

Mrs. BIGGERT. Thank you. I apologize for not being here before to hear that, but I thank you for your answer.

I would yield back.

Chairman BOEHNER. The Chair recognizes the gentleman from Massachusetts, Mr. Tierney, for 5 minutes.

Mr. TIERNEY. Thank you, Mr. Chairman.

I thank the members of the panel.

We've seen discussed, or heard discussed here this morning, the yield curve and the fact that it's based on the notion of matching—of the company's funding liabilities with the age of the workforce or the duration of the plan.

In absence of that yield curve or even as a complementary approach to it, is there even more that we can be doing to ensure that the company's investment decisions are more closely matched to the plan's duration?

Mr. WARSHAWSKY. Congressman, we feel as if it's not the position of the government, whether through the PBGC or through any other agencies or in the rules to tell companies how to—what assets to select.

Mr. TIERNEY. If I can interrupt you for 1 second and have a little dialog here, I don't mean to be rude, but isn't that in essence what you're trying to do a little bit with the yield curve, not tell them so much, but lead them?

Mr. WARSHAWSKY. We feel as if we're giving the company's plan sponsors the tools to manage the uncertainty and the risk.

Certainly asset allocation is one tool that they can use, but there are other tools that we are giving them.

Mr. TIERNEY. So is that a yes? I mean, I just—

Mr. WARSHAWSKY. I would say it's a no, actually.

Mr. TIERNEY. It's a no?

Mr. WARSHAWSKY. Meaning I would say that it's really something that we don't know what plan sponsors will do. We hope Congress will—

Mr. TIERNEY. Well, why did you do it if you don't know what they're going to do? What was the purpose of using the yield curve if you don't know what the results will be?

Mr. WARSHAWSKY. The purpose of using the yield curve is to get the most accurate measurement of the liability that we can.

Mr. TIERNEY. You do that without any consideration of what effect it might have in terms of encouraging investors one way or the other; is that what you're saying?

Mr. WARSHAWSKY. As I say, we feel as if it's most important to get accuracy for the plan participants for the government agency, for investors.

Mr. TIERNEY. Right, and did you do it without any consideration at all for what effect it may have?

Mr. WARSHAWSKY. No, we certainly have done extensive modeling of the proposal.

Mr. TIERNEY. And as a result of that, what do you think using that yield curve will do in terms of affecting the investments made?

Mr. WARSHAWSKY. With regard to investments made, we really do not know, because it has to be done in the environment of the entire proposal.

Mr. TIERNEY. So you did no modeling on that?

Mr. WARSHAWSKY. No, we did not.

Mr. TIERNEY. OK. And you did not have any intentions of affecting it one way or the other?

Mr. WARSHAWSKY. That was not top of mind in our considerations.

Mr. BELT. Congressman, if I might add to that?

Mr. TIERNEY. Please do.

Mr. BELT. I mean, one of the—our position was that that's a business decision to be made by the CFO and CEO, just as they do with an airline company trying to figure out where fuel prices are going to be.

Some decide to bear that risk and not hedge their fuel prices and just figure out they'll buy fuel, whatever the price is down the road. Some of them try to manage that.

Same thing with the car companies that don't know where steel prices are going to be or financial services firms that have to deal with interest rate risk, market risk, and currency risk. Those risks are inherent in the system.

It's the business decision of the company as to how best to manage that risk, and it's the decision of the shareholders. We don't want to dictate that.

But there's no question that, as with all of these risks, companies should be paying attention to what the risks are on both the asset and liability side, and making an informed decision.

Mr. TIERNEY. Well, I would hope. I mean, you know, it's the employees that are going to take it in the neck if they don't, and I think history shows us that those that heavily invest in equities end up having more difficulty with their pension plans than those that maybe are a little more heavily invested in some more secure and stable vehicles.

So that's why I asked whether or not there's been any sort of a policy decision here to sort of give an impetus to companies to go a little bit more on the more stable types of investments, a little less risky in the long run, so that the people that are relying on this pension will have a little more assurance that it might be there.

Mr. BELT. Well, from the prospective insurer, I mean, that's an issue again, a business decision to be made, but if the company was not at all a credit risk, it was a very financially solid company, from our standpoint, I would be less concerned if they were taking a little bit more risk elsewhere.

Maybe the shareholders think that that's a reasonable business decision to make. That's a business decision that's made, not—

Mr. TIERNEY. Well, I guess it's a business decision to be made, and the shareholders and all that, but the real stakeholders in this apparently don't get a say, and I think that's where you might think that government would step up and maybe go to bat for them a little bit on some of this.

Let me ask another question if I could, because I'm sort of intrigued with the idea of the Pension Benefit Guaranty Corporation having some protection for the pensions rights of employees if they go into bankruptcy.

But then there's been some pushback by people who, of course, think that that might discourage the lending community from ex-

tending financing to troubled companies, and in fact result in more bankruptcies.

Would each of you discuss that a little bit for me, and how you come down on that, what the considerations are?

Mr. BELT. One part of the administration's proposal is that PBGC would be able to, in contrast to current law, be able to enforce a lien in bankruptcy for missed contributions.

We can enforce that lien outside bankruptcy right now. A lien arises automatically by operation of law under Section 412 in the Internal Revenue Code, and we can enforce that.

We can't in bankruptcy. It's automatically stayed. And that was the situation that arise with respect to United.

But Mark had alluded to this earlier, and the Chairman had as well, that ultimately, this is a balancing of interest with respect to the bankruptcy code or anything else.

Obviously, there are those who would not want PBGC's position elevated in any way, shape, form, or fashion. My personal view is that with appropriate changes, such as the being able to force the lien, you actually create the right incentives on a go-forward basis that creditors would actually be having covenants in their debt agreements to encourage companies, or insist that companies keep their plans fully funded, because they would not want to have the PBGC have a seat at the table.

Chairman BOEHNER. If the gentleman would yield?

Mr. TIERNEY. I will, certainly.

Chairman BOEHNER. The gentleman was referring to the return on bonds versus equities, and if the gentleman would look over the last 20 years, the last 40 years, the last 80 years, equities would tend to produce about twice the gains of bonds.

Now, in the short term, any short term window, you could probably find an example of where that wasn't the case.

Mr. TIERNEY. Reclaiming my time, just looking it from a different perspective, looking at the number of plans that have failed and the fact that they have more heavily invested in equities than the plans that are more—that have continued to be stable pension plans, I see it the other way around, but we can have that argument—

Chairman BOEHNER. Well, if the gentleman would continue to yield—

Mr. TIERNEY. Of course, Mr. Chairman.

[Laughter.]

Chairman BOEHNER. —most of the plans who have, quote, in your words, failed, have failed because the employer didn't put the sufficient funding into the plan and probably because of business conditions that they may have dealt with in the marketplace.

Mr. TIERNEY. That may be partially correct, but some of them have failed just because they took bad investments at risky times and over the hill it went, but we can collect all that. The facts will be shown and the data, and then we can probably debate it better there.

But I want to thank the witnesses for their contribution and their answers. Thank you.

Chairman BOEHNER. And I'd like to thank the witnesses for their excellent testimony and their willingness to help us better under-

stand the administration's proposal, and with that, dismiss the first panel and invite the second panel to come forward.

Mr. Porter, your microphone is on. You might want to turn your microphone off.

We want to invite and thank our second panel, thank them for their patience, and it's my privilege to introduce them.

Our first witness on the second panel will be Mr. Kenneth Porter. He's the director, corporate insurance and global benefits financial planning at the DuPont Company.

He's responsible for global property and casualty insurance risks, and for the worldwide financial planning and actuarial policy for employee and retiree benefits.

Mr. Porter previously served as chair of the ERISA Industry Committee and the American Benefits Council.

We will then hear from Mr. Norman Stein, who is the Douglas Arant Professor of Law at the University of Alabama School of Law in Tuscaloosa, Alabama.

He has taught law for over twenty years, specializing in the areas of tax, labor, and employee benefits.

From 1996 to 2004, he was director of Pension Counseling Clinic, which is supported by the United States Administration on Aging.

We will then hear from Dr. Janemarie Mulvey, who is the chief economist of the Employment Policy Foundation, a nonprofit, nonpartisan economic policy research foundation that promotes workforce and employment policy.

Dr. Mulvey is a nationally recognized expert on retirement security issues with over 20 years experience conducting research in the areas of pensions, health, and long-term care insurance.

And with that, Mr. Porter, we're anxious to hear your testimony.

**STATEMENT OF KENNETH W. PORTER, DIRECTOR OF CORPORATE INSURANCE AND GLOBAL BENEFITS FINANCIAL PLANNING, THE DuPONT COMPANY, WILMINGTON, DE, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL**

Mr. PORTER. Thank you, Mr. Chairman and Members of the Committee. Thank you for the opportunity to appear here.

In addition to the things that the Chairman indicated, I would point out that by profession, I'm an actuary, serve as the chief actuary of the DuPont Company.

I'm serving as spokesperson today, however, for the American Benefits Council, and joining the testimony is the American Council of Life Insurers, Business Roundtable, the ERISA Industry Committee, National Association of Manufacturers, and the U.S. Chamber of Commerce.

Mr. Chairman, we commend you and Mr. Johnson and the other Members of the Committee for your leadership in the defined benefit pension reform. The six principles that you outlined last September will serve as an excellent foundation for very much needed pension reform.

We also commend the administration for stepping outside the box and proposing sweeping changes to the rules governing pension funding and pension protection.

The administration's proposals encourage us to challenge the status quo, and we agree that important changes are needed soon.

In the end, the rules that we ultimately adopt must reflect the best possible solution for the long-term health of the defined benefit system in the United States.

Annual pension contributions for many companies can number in the hundreds of millions or even billions of dollars. In the aggregate, private sector plans hold nearly $2 trillion in assets.

Accordingly, direct or indirect changes to this system can have a significant impact on the investment markets, on the economic growth, and job creation.

Not only do we agree that funding rules need to be strengthened, we also agree that broader, more timely disclosure to plan participants is needed, and that the proposals to allow employers to make larger contributions during good economic times is long overdue.

In addition, we agree that meaningful safeguards should be considered that would adequately protect the PBGC.

I would add that it is not the government that receives the liability for these benefits. It's plan sponsors. Ultimately, it's only the plan sponsors that can support the PBGC's finances, other than its own investment results.

However, we have serious concerns about certain aspects of the proposal.

Our primary concerns are that the proposal would dramatically impair the ability of plan sponsors to predict pension funding and premium requirements; it would introduce counterproductive and troubling use of credit ratings; create a strong disincentive to prefund; and exacerbate periods of economic weakness, causing job losses and intensifying the downward spiral of companies that experience difficulties in those times.

We're not simply here to talk about those aspects of the administration's proposal, however. We believe the American Benefits Council has developed a very forward-thinking, progressive set of rules to improve the status of the pension system. These ideas are set forth in our written statements that have been submitted for inclusion in the hearing record. Pension plan funding is a long-term undertaking. Proposals to tie pension funding to point in time interest rates have a lot of public appeal when the interest rates are low, like they are today, but we must face the fact that long-term interest rates have averaged more than 9 percent over the last 28 years, and they haven't been as low as they are today in more than 40 years.

It could be more than dangerous to our economy and the creation of jobs if we were to make precipitous changes to pension funding rules in response solely to today's unusual environment.

Spot valuations are neither accurate nor predictable. They undermine a company's ability to make pension business and business plans, they undermine a company's ability to meet its funding obligations.

Moreover, pension plans' liabilities can vary by as much as 15 percent, depending on whether the yield curve is steep, whether it's flat, or whether it's inverted.

It's very difficult for us as plan sponsors to understand how the shape of the yield curve over a 90-day period has any relevance on whether the plan can meet its obligations over the next 50 years.

One of the stated objectives of the proposal is to encourage plan sponsors to increase their voluntary funding. Unfortunately, this is not always the case.

For example, many of the contributions that were actually contributed to pension plans during the early 1980's may not have been permitted under this assumption and under this proposal. Plans would therefore be less funded.

The reason for this is that interest rates were very high during that period of time. The administration's proposal would actually curtail very sharply the ability of company's to make contributions during periods of high interest rates.

The plan, if it had been fully funded, based on a very high interest rate, would have looked very nice to the public, it would have looked very nice to the plan participants, but in the end, when the interest rates went down, it would have been grossly under-funded.

So basing pension plan funding on interest rates alone has very dangerous consequences.

As a result, we believe that the administration's proposal would eliminate the plan sponsor's ability to prudently manage its cash-flow by pre-funding in subsequent years of contribution when times are good, especially if the interest rates are high.

Also, being able to manage on a day-to-day basis, a year-by-year basis, based on when cash-flow is there would be virtually eliminated by the administration's proposal.

They have asked for and stated that they would increase their proposal in time.

Mr. Chairman, I'll conclude in a moment, if you just bear with me for one last statement.

We're concerned about basing funding on pension credit ratings. In addition to the harm that could do to companies, we look at the fact that credit rating agencies are not bound by pension rules.

They may have needs to change what they do ion the future. They may have to be required to change what they do in the future.

We believe it's very dangerous to tie the economic health of millions of Americans to a credit rating system that may change unilaterally.

We have experience with that, because our current debate around pension funding originally started because thirty-year Treasury bills, which pension funding was tied to, were eliminated.

We believe that we need to step forward and start making permanent the funding rules adopted last year, the temporary long-term bond rate, and concurrently, we must focus on the necessary changes to make the current system work so that we can deal with both economic times when interest rates are high, as well as interest rates are low.

Thank you, Mr. Chairman.

I'll entertain your questions.

[The prepared statement of Mr. Porter follows:]

**Statement of Kenneth W. Porter, Director of Corporate Insurance and Global Benefits Financial Planning, The DuPont Company, Wilmington, DE, on behalf of the American Benefits Council**

Chairman Boehner, Mr. Johnson, and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is Kenneth W. Porter,

Director, Corporate Insurance & Global Benefits Financial Planning, The DuPont Co. I am serving as a spokesman today, however, for the American Benefits Council, a public policy organization representing principally large companies and other organizations that assist employers of all sizes in providing benefits to employees. Our members either sponsor directly or provide services to retirement and health plans covering 100 million Americans. The American Council of Life Insurers, Business Roundtable, the ERISA Industry Committee, the National Association of Manufacturers, and the US Chamber of Commerce also join in the views expressed in this testimony. We come before you today with a common voice because we all have a vital interest in encouraging the creation of a regulatory climate that fosters the voluntary creation and maintenance of defined benefit pension plans.

Mr. Chairman, we commend you, Mr. Johnson, and the other members of the Committee for your leadership on defined benefit pension reform. The six principles that you outlined last September for guiding congressional efforts to modernize the pension laws provide an excellent foundation for needed pension reform. These principles should help to protect the interests of plan participants while ensuring that any reforms are carefully targeted to specific problems and are not unnecessarily disruptive.

We agree that reforms are needed to revitalize and support the defined benefit pension system. It is critical that these reforms focus on our ultimate goal: retirement security. Because of the reported deficits at the Pension Benefit Guaranty Corporation (the "PBGC"), there is a risk that reform efforts will be focused on the PBGC. While we wholeheartedly agree that the PBGC must be protected, we should not lose sight of the fact that the PBGC was set up to strengthen retirement security through the defined benefit plan system. It would be tragic and counterproductive if the PBGC is strengthened at the expense of the pension system as a whole.

A few weeks ago, the Administration released its funding proposals. The American Benefits Council has also released a set of reform proposals in a report, Funding Our Future: A Safe and Sound Approach to Defined Benefit Plan Funding Reform (February 2005), which is attached to this testimony. That report includes a comprehensive discussion of the Council's proposals as well as an analysis of the Administration's ideas.

We commend the Administration for releasing its reform proposals and there are a number of themes in the Administration's package that we support. For example, we agree that the funding rules need to be strengthened. We also agree that more timely disclosure to plan participants is needed and that measures to allow employers to make larger contributions during good economic times are long overdue. In addition, we agree that meaningful safeguards should be considered to protect the PBGC from benefit enhancements adopted at a time when the sponsor is unlikely to properly fund those enhancements.

However, we have serious concerns about many of the Administration's proposals. Our primary concerns are that the proposals would (1) drastically restrict the predictability of funding and premium obligations; (2) introduce a counterproductive and troubling use of credit ratings; (3) create a strong disincentive to pre-fund; (4) burden the defined benefit plan system with PBGC premium increases that are not warranted; and (5) fail to stand the test of time. We fear that the net result would be fewer defined benefit plans, lower benefits, and far more pressures on troubled companies that jeopardize the companies' ability to recover.

The remainder of this testimony outlines certain reforms that we believe should be enacted and describes our analysis of certain aspects of the Administration's proposals.

*Permanent replacement of the 30-year Treasury rate*

We strongly recommend permanently replacing the 30-year Treasury bond rate used for pension calculations with the long-term corporate bond rate that Congress enacted on a temporary basis last year. Prior to the Pension Funding Equity Act of 2004, the 30-year Treasury bond interest rate was required to be used to determine the "current liability" of a defined benefit plan. "Current liability" is, in turn, used in certain circumstances to determine how much a plan sponsor must contribute in a year to fund a plan. The 30-year Treasury bond interest rate was also required to be used for various other pension purposes, including determining the amount, if any, that is owed to the PBGC as a variable rate premium.

The 30-year Treasury bond rate has become artificially low compared to other interest rates because of Treasury's buyback program (which started in the late 1990's) and because of the discontinuance of the 30-year Treasury bond in 2001. The use of this low rate for pension purposes artificially inflates pension liabilities and funding obligations. If applicable, these inflated obligations will have adverse effects

on the nation's economy. In addition, concerns regarding unrealistic funding obligations have already led companies to freeze plan benefits and many more companies will likely do so if a permanent replacement for the 30-year Treasury bond rate is not enacted soon.

Congress recognized that the 30-year Treasury bond rate was a "broken rate" last year and enacted a temporary solution, permitting the use of a long-term investment grade corporate bond rate for 2004 and 2005. That was the right action at the time. Now is the time to make that change permanent. The long-term corporate bond rate reflects a conservative estimate of the rate of return a plan can be expected to earn and is an appropriate discount rate. Businesses need to be able to make projections about future cash flow demands so that they can make sound plans for the future. The temporary nature of the rule in effect today makes planning difficult and can undermine a company's commitment to the defined benefit plan system.

The Administration has proposed, as an alternative to the long-term corporate bond rate, a "yield curve." We appreciate that the Administration's proposal recognizes the need to replace the obsolete 30-year Treasury bond. In particular, we are pleased that the Administration recommends replacing the 30-year Treasury bond with a yield curve that uses a conservative, high-quality corporate bond rate. The proposal, however, differs in two fundamental respects from our proposal. First, the yield curve interest rate is a "near-spot rate" rather than a four-year weighted average rate. This aspect of the Administration's proposal is discussed in a subsequent section of this testimony. Second, the yield curve proposal would apply different interest rates to different payments to be made by the plan based on the date on which that payment is expected to be made.

The yield curve proposal is troubling in several respects. First, the proposal would generate numerous different interest rates for each participant. This level of complexity may, at best, be manageable by some large companies; it would impose an unjustifiable burden on small and mid-sized companies across the country. Second, the proposal is intended to reflect the market and thus be "accurate"; in fact, the markets for corporate bonds of many durations are so thin that the interest rates used would actually need to be "made up", i.e., extrapolated from the rates used for the other bonds.

Moreover, as we understand the yield curve proposal, it would reduce the effective discount rate for the typical mature plan below the long-term corporate bond rate. In many cases, the result would be a significant increase in liability. For mature plans, the increase could be more than 10 percent. Using a lower effective discount rate than the long-term corporate bond rate would result in contributions that would be materially in excess of those needed to pay benefits. The long-term corporate bond rate is a very conservative estimate of the rate of return a plan can expect to earn over the long term and thus is an economically sound discount rate. Excessive contributions are in no one's interest, particularly for mature plans in industries that can least afford to have a sudden required increase in funding obligations. In addition, plans that are already sufficiently funded to cover all future benefits using modern econometric modeling (which simulates a universe of possible outcomes) would appear underfunded under the Administration's proposal and thus could be required to pay PBGC variable rate premiums and to make substantial contributions that, in all probability, will be excessive to the needs of the plan.

*Preventing the volatility that ould be created by spot valuations*

From business' perspective, perhaps the most important issue relating to defined benefit plans is predictability. Companies need to be able to make plans based on cash flow and liability projections. Volatility in defined benefit plan costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these costs be predictable.

The essential elements facilitating predictability under current law are:

(1) the use of the four-year weighted average of interest rates discussed above, and

(2) the ability to smooth out fluctuations in asset values over a short period of time (subject to clear, longstanding regulatory limitations on such smoothing).

Some have argued, however, that the measurement of assets and liabilities should be based on spot valuations and that volatility can be addressed through smoothing contribution obligations. This approach is seriously flawed in four respects. First, spot valuations are not necessarily accurate. For example, the spot interest rates from late 2002 were very poor indicators of interest rates for 2003. It simply is not logical to conclude that a spot interest rate for one short period is "the" accurate rate for a subsequent 12-month period. Second, advocates for spot rates have not proposed smoothing mechanisms that would make contribution or premium obliga-

tions predictable. Third, there has been no recognition of the numerous other rules (e.g., deduction limits, benefits restrictions) that do not relate to contribution obligations and that would become volatile if asset and liability measurements were based on spot valuations. Fourth, the shape of the yield curve itself would add to volatility. The yield curve can change shapes dramatically over very short periods of time. Modeling shows that pension liabilities for a mature pension plan can vary by 15% or more depending on whether the yield curve is steep, flat, or inverted. We find it hard to comprehend how the snap-shot shape of the then-current yield curve can contribute to stable funding of pension benefits that will be paid out over extended periods of time. For these reasons, we believe that current-law smoothing rules should be preserved.

There has been a significant amount of discussion by government officials and members of the media indicating that defined benefit plans should be invested in bonds rather than in equities. The bond proponents argue that this would address business' concerns with volatility, as well as protect PBGC and plan participants. In the strongest possible terms, we oppose any legal structure that penalizes plans for investments in equities. For the reasons discussed below, we believe that any such structure would be disruptive and harmful to plans, companies, participants, and the economy as a whole.

If a yield curve or other fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it would have a marked effect on the stock market, the capital markets, and capital formation generally. Hundreds of billions of dollars could move out of the equity markets with dangerous economic consequences.

Over time, pension plans earn more on investments in equities than in bonds. If plan earnings decline because plans are compelled to invest in bonds or other low-yielding instruments, plans' overall costs will rise. As plans become more expensive, it goes without saying that there will be fewer plans and lower benefits in the plans that remain.

One primary argument made by the bond proponents is that plan investment in bonds can be used to "immunize" the plan with respect to its liabilities. The bond proponents contend that employers can insulate themselves from both volatility and liability by investing in bonds. First, it is far from clear that there could ever be enough high-quality bonds available to permit plans to immunize in this manner. During the ratings process, the credit rating agencies consider pension plan underfunding and expected near-term pension funding requirements. Adoption of this proposal would increase reported underfunded liabilities and, more importantly, materially increase expected near-term cash flow. It follows, that potentially fewer high-quality bonds will exist after the proposal is enacted. Thus, if plan sponsors were to try to immunize their plans by buying bonds, they would be forced to include lower-quality bonds in their portfolios. Thus, true immunization may not be possible.

But even if there were enough high-quality bonds to go around, the immunization arguments do not hold up to scrutiny. Even the staunchest bond proponents acknowledge that there are numerous pension liabilities that cannot be immunized. For example, because mortality cannot be predicted with precision, it is not possible to immunize a plan that makes life annuity payments. Similarly, the number of people who retire and take available subsidies can only be estimated and thus that liability cannot be immunized.

Bond proponents respond to these concerns by maintaining that in a large pool, mortality and retirement assumptions can be predicted with reasonable accuracy. This answer is deficient in two crucial respects. First, it is not applicable to small and mid-sized plans where there is not a large pool. Second, retirement assumptions are made based on reasonable predictions. Obviously, these assumptions do not anticipate unexpected retirement of large numbers of early-retirement eligible employees. Nor do they recognize emerging economic factors that might tend to encourage employees to remain employed longer than in the past.

The end result of "immunization" is: (1) a lower rate of plan earnings and correspondingly higher company costs, (2) resulting lower benefits, and (3) a system that systematically ensures large PBGC liabilities whenever a plan has unexpected retirements of early-retirement eligible workers. The higher long-term rate of return available with equities is what makes plans affordable for companies. These rates of return also are the most effective means for all affected parties to weather a downturn in the business of the sponsoring employer. Investing in equities is critical to the successful functioning of the defined benefit plan system for companies, participants, and the PBGC. Thus, it is critical that the law not establish rules that adversely affect plans investing in equities.

*Rules based on an employer's creditworthiness*

We are deeply concerned about the Administration's proposal to base the application of the pension funding and premium rules on the creditworthiness of the employer sponsoring the plan. These rules, in and of themselves, could cause permanent harm to some companies that would otherwise continue funding their pensions for many years.

Many companies that are not considered "investment grade" by the credit rating agencies, nevertheless continue, year after year, to generate cash, pay their employees, pay their bills and fund their pension plans. The mere fact that a company's debt is rated below investment grade does not mean that it will terminate its plans. However, the Administration's proposal would classify many plans that would otherwise never be terminated as "at risk." These classifications could become a self-fulfilling prophesy as a precipitous increase in pension funding and premium requirements could reduce the ability of many companies to continue operating. It is in everyone's interest for these companies to continue maintaining and funding their plans.

This proposal would also likely cause investment-grade companies with lower credit ratings to be downgraded below investment grade. This would occur because (a) excessive conservatism in the funding rules would increase the projected near-term cash requirements (an important factor in determining credit rating), and (b) the credit rating agencies might be influenced by the additional funding requirements that would result if the credit rating were downgraded. Impacted companies would not only be required to dramatically increase their pension funding, but they would also be required to significantly increase their cost of debt, if they are able to obtain financing at all.

In addition, having PBGC premium levels or funding rules turn on an employer's creditworthiness would also exacerbate the downward spiral currently experienced by companies that are downgraded. Those pressures would undermine companies' ability to recover, which adversely affects all parties, including the PBGC. Finally, there is no practicable way to apply a creditworthiness test to non-public companies.

*Permitting additional contributions in good times*

The lesson of the last 10 years is that companies need to be permitted and encouraged to make additional contributions in "good economic times" so that plans have a funding cushion to rely on during "bad economic times." Trying to squeeze huge contributions from companies during a downturn in the economy will only lead to freezes on benefits, company bankruptcies, and large liabilities shifted to the PBGC. The time to build up pension assets is during good economic times, not bad times.

The Administration's proposal has the laudable objective of encouraging funding in better days. However, we are concerned that the proposal may fall short of achieving this goal, particularly in higher interest rate environments. For example, many of the contributions actually made by plan sponsors during the early 1980's might not have been permissible had this proposal been in effect at that time. Interest rates during that time were substantially in excess of the long-term funding assumptions used by plan sponsors under ERISA, which provided the basis for deductible contributions in those years. If the Administration's proposal had been in effect, some of those contributions would not been made and plan sponsors would have had fewer assets earning the large investment returns that were realized during the 1980's and 1990s.

Increase in the deduction limit. We strongly support the Administration's proposal to increase the deduction limits currently in Code section 404(a)(1)(D) from 100 percent of current liability to 130 percent. In fact, we would recommend increasing the 130 percent figure to 150 percent to ensure that there is an adequate cushion. For deduction purposes, current liability is today based on the 30-year Treasury bond rate, not the long-term corporate bond rate. Under our proposal, current liability would in the future be based on the long-term corporate bond rate for all purposes. This would, in isolation, actually decrease the deduction limit for many plans by 10 percent or 15 percent (and by more for a few plans). Accordingly, to ensure that the deduction limit for most plans is increased by 30 percent compared to current law, the limit should be increased to approximately 150 percent.

Repeal of the excise tax on nondeductible contributions. We also support repealing the excise tax on nondeductible contributions with respect to defined benefit plans. The excise tax on nondeductible contributions only discourages employers from desirable advance funding.

Repeal of the combined plan deduction limit. Finally, we support repealing the combined plan deduction limit for any employer that maintains a defined benefit plan insured by the PBGC. Under present law, if an employer maintains both a defined contribution plan and a defined benefit plan, there is a deduction limit on the

employer's combined contributions to the two plans. Very generally, that limit is the greatest of:

(1) 25 percent of the participant's compensation,

(2) the minimum contribution required with respect to the defined benefit plan, or

(3) the unfunded current liability of the defined benefit plan.

Without repeal of this provision, the sponsor of a plan with large numbers of retirees might lose its ability to make deductible contributions to its defined contribution plan. In a mature plan, the number of active participants is small compared to the number of retired participants. As a result, 25% of participant compensation could be less than 5% of the pension plan's liabilities. The Administration's proposal exacerbates this situation because it dramatically reduces the discount rate for mature plans. This simultaneously causes the plan's service cost to increase as a percent of pay, and the plan's funded status to decline. Even if a mature plan is 90% funded on this more conservative basis, the resulting minimum funding requirement could approach or exceed 25% of participant compensation before considering the deduction for the defined contribution plan.

This deduction limit can also cause very significant problems for any employer that would like to make a large contribution to its defined benefit plan. There is no supportable policy reason for preventing an employer from soundly funding its plan. Defined benefit plans and defined contribution plans are each subject to appropriate deduction limits that are based on the particular nature of each type of plan. There is no policy rationale for an additional separate limit on combined contributions.

*Eliminating barriers to pre-funding*

Under current law, an employer maintaining a defined benefit plan is generally required to make certain minimum contributions to the plan. An employer may, however, choose to contribute amounts in excess of the minimum required. Such "extra" contributions give rise to a "credit balance", i.e., a type of bookkeeping record of the excess contributions made by an employer.

Present law is carefully crafted not to discourage "extra" contributions. To this end, in years after a credit balance is created, an employer's minimum funding obligation is determined as if the amount of any credit balance were not in the plan. Then, the credit balance is applied against the minimum funding obligation determined in this manner. In this way, the law is carefully crafted with respect to a company's decision whether to make extra contributions. The law is structured to treat a company that makes an extra contribution in one year and uses the resulting credit balance in a subsequent year in the same manner as a company that only makes the minimum contribution in all years.

If credit balances were not available to satisfy future funding obligations, employers would have a clear economic disincentive to fund above the minimum levels; funding above the minimum levels would, in the short term, decrease funding flexibility and increase cumulative funding burdens. If an employer does not receive credit for extra contributions, the employer will have an incentive to defer making contributions until they become required.

The credit balance system has been criticized on the following grounds: Critics have pointed to examples of underfunded plans that have not been required to make contributions because of credit balances. Some of those plans have had their liabilities transferred to the PBGC. One possible response to this criticism would be to prohibit the use of credit balances in the case of underfunded plans, as the Administration has proposed. For employers that previously have made advance contributions in reliance on the current law rules, any retroactive changes to the credit balance rules raise fundamental questions of fairness. On a prospective basis, at first blush, this type of proposal would seem to increase funding. In fact, the opposite is true. Such a proposal would lead to more underfunding and more PBGC liability. If contributions above the minimum amount are discouraged, few if any companies will make extra contributions. That can only lead to more underfunding. For example, if the use of credit balances were restricted, the companies cited by the critics would likely not have made extra contributions and accordingly, even greater liabilities would have been shifted to the PBGC and the PBGC would have assumed these liabilities sooner.

The other criticism of credit balances is that they are not adjusted for market performance. For example, assume that a company makes an extra $10 million contribution. Assume further that the plan experiences a 20 percent loss with respect to the value of its assets during the following year. Under current law, the $10 million credit balance grows with the plan's assumed rate of return (e.g., 8 percent) until it is used. So after a year, the credit balance would be $10.8 million. The crit-

ics argue that the credit balance should actually be $8 million in this example, to reflect the plan's 20 percent loss. This concern regarding market adjustments is a valid concern that should be addressed legislatively on a prospective basis and should apply to both increases and decreases in market value.

As noted above, employers need to be encouraged to make extra contributions in "good times" so that they will have a sufficient cushion for the "bad times." If the use of credit balances is restricted, companies would not make extra contributions except in unusual circumstances. It goes without saying such a restriction that would be a major step backward. If we want companies to fund more in good times, it is essential that we preserve the credit balance system.

*PBGC Premiums*

The PBGC has proposed dramatic increases in premiums in order to address its deficit. This proposal gives us great concern for several reasons. First, the proposed increase in the flat dollar premium from $19 to $30 and its indexing is strikingly inappropriate. This is a substantial increase on the employers that have maintained a well-funded plan through a unique confluence of lower interest rates and a downturn in the equity markets. It is wrong to require these employers to pay-off the deficit created by underfunded plans that have transferred liabilities to the PBGC. Many of these plans are well-funded by any other measure, but under the proposal might be deemed "underfunded" and now be required to pay variable rate premiums on top of this higher base premium. Second, the unspecified increase in the variable rate premium will become a source of great volatility and burden for companies struggling to recover. This could well cause widespread freezing of plans by companies that would otherwise recover and maintain ongoing plans. This would only be exacerbated by the fact that the PBGC has proposed an unprecedented delegation of authority to its Board, rather than Congress, to determine the required premiums. Third, a premium increase misses the point of the last 10 years. The solution to underfunding is better funding rules, not higher premiums.

More generally, there has been a striking lack of clarity about the real nature of the PBGC deficit. The PBGC has reported a $23 billion deficit as of the end of FY 2004 but there are a number of questions about the PBGC's situation. First, a substantial portion of the PBGC's reported deficit represents "probable" terminations rather than actual deficits. Second, the PBGC's numbers are based on a below-market interest rate and the deficit may be substantially less using a market-based interest rate. Third, interest rates are at historic lows and just a few years ago in 2001, the PBGC was operating at a surplus. It would be useful if we could put the PBGC deficit into context by understanding the effects of a return of interest rates to historic norms. Finally, it is not clear why the PBGC has unilaterally moved away from equities to lower-earning investments that hinder its ability to reduce its deficit. No one denies that the PBGC faces a serious situation, and our comprehensive proposals for funding reform are evidence that the employer community is serious and committed to shoring up the PBGC's financial condition. However, these are troubling questions that should be addressed before taking the very harmful step of increasing PBGC premiums.

*Lump sum distributions*

The discount rate used to determine the amount of a lump sum distribution should be conformed to the funding discount rate (which, as discussed above, should be the long-term corporate bond rate). Under current law, a rate no higher than the 30-year Treasury rate must be used to determine the lump sum distributions payable to participants in defined benefit plans that offer lump sums. As the 30-year Treasury rate has become artificially low, it has had the corresponding effect of artificially inflating lump sum distributions (i.e., the lump sum projected forward using a reasonable rate of return is more valuable than the annuity on which it was based). This has had very unfortunate consequences.

First, these artificially large sums are draining plans of their assets. For example, if a plan determines its funding obligations based on the long-term corporate bond rate, but pays benefits based on a much lower rate (such as the 30-year Treasury rate), the plan will be systematically underfunded. For the defined benefit plans that offer lump sums (roughly half the plans), the centerpiece of funding reform—the replacement of the 30-year Treasury bond rate—will simply be illusory unless the lump sum discount rate is conformed to the funding rate. Second, participants have clear economic incentives to take lump sum distributions, instead of annuities. The discount rate should not artificially create an uneven economic playing field that discourages annuities.

We recognize that the artificially large lump sums of recent years have built up employee expectations. For employees near retirement (e.g., within 10 years of nor-

mal retirement age) who have made near-term plans based on present law, transition relief is clearly appropriate. But in the strongest terms, we urge policy makers not to go further than that. If over the next 10 to 15 years, plans are required to give inflated distributions to retirees, that can only hurt the defined benefit plan system and future participants. In the competitive world we live in, pensions are at best a zero sum arrangement. If employers have to pay inflated benefits for 10 or 15 years, they will have to recoup that cost in some way. It is our fear that many will feel compelled to reduce benefits for the next generation, a reduction that will likely carry forward to all future generations.

We support the Administration's proposal to conform the interest rate used for determining the amount of a lump sum distribution to the funding discount rate. However, applying the yield curve to determine lump sums would (1) appear to further increase the value of lump sums and thus exacerbate the current law problems described above, (2) increase benefits for higher paid employees who can afford to let their benefits remain in the plan longer, and (3) force a significant reduction in cash balance plan benefits. For these reasons, we oppose using a yield curve to determine lump sums.

*Disclosure*

Like the Administration, we strongly support enhanced disclosure of a plan's funded status. The current-law disclosure tool, the summary annual report ("SAR"), provides information that is almost two years old. That is inadequate. We believe that all plans should be required to disclose to participants year-end data on the plan's funded level within a shorter time frame.

Year-end data would consist of year-end asset valuation, as well as beginning-of-the-year current liability figures projected forward to the end of the year, taking into account any significant events that occur during the year (such as a benefit increase). Plans should have the option to use year-end financial accounting standards data in lieu of the above data. Pension actuaries have struggled during the first two months of 2005 to comply with the combined effects of (a) compressed year-end financial disclosure timing imposed on plan sponsors by the Securities and Exchange Commission and (b) the implications of Sarbanes–Oxley legislation. Concurrently, the rapid decline in the number of pension plans over the last 20 years has moderated the number of new actuaries who embrace the difficult rigors of pension actuarial work. Because the required disclosure must first be developed by a limited number of qualified actuaries, there is a physical limit as to the amount of work that can be completed during the first six weeks of any year. In our view it is unrealistic to stipulate yet another set of computational rules and requirements on a thinly-stretched, yet vital, resource when reasonable alternatives already exist.

Other proposals would achieve less disclosure, and some of the other proposals would have serious adverse effects. Some proposals have been based on the SAR and thus give rise to disclosures that are out-of-date. Other proposals would require disclosure only from employers with plans that are more than $50 million unfunded. Those proposals are inadequate. For example, those proposals would not apply to a plan with $60 million of liabilities and only $20 million of assets. Moreover, those proposals inappropriately target large plans. $50 million represents less than ° of 1% of liabilities for large plans (e.g., $10 billion or more of liabilities). Such, a large plan could be 99.5 percent funded but would be subject to disclosure under the proposals with the accompanying inappropriate stigma of being "so under-funded" as to be one of the few plans subject to this additional disclosure. Certain executive branch agencies have discussed using termination liability (instead of current liability) for disclosure purposes, which is significantly higher than current liability. That could mislead and alarm participants in the vast majority of plans that are not terminating.

*Transition*

In certain circumstances, a combination of economic forces—such as competitive changes within an industry, the aging of a company's workforce, falling interest rates, and a downturn in the equity markets—can result in a dramatic change in the viability of a company's defined benefit plan. In those cases, following the otherwise applicable rules can only lead to plan termination and severe economic troubles for the company sponsoring the plan. It is critical that we develop a different solution for these troubled plans. We recommend that alternative approaches be developed that would address this situation in a way that does not increase PBGC exposure, but rather is structured to reduce that exposure. For example, proposals could be considered that would generally result in a company in this situation ceasing benefit accruals (or pay for any new accruals currently) and funding the shortfall over a longer period of time. Other proposals may also be discussed.

More generally, as pension funding reform moves forward, transition issues need to be carefully studied. Large additional funding burdens that are suddenly imposed can disrupt business plans and cause otherwise viable companies to become insolvent. Such insolvencies would only increase burdens on the PBGC. Fairness also dictates that the rules be phased in slowly for participants, unions, and companies that have structured their arrangements based on present-law rules.

*Hybrid Plans*

Mr. Chairman, we appreciate your leadership on the need for a positive resolution to the uncertain status of hybrid plans, such as cash balance and pension equity plans. We also strongly support legislation affirming the legality of hybrid plans designs. Nearly a third of large employers with defined benefit plans maintain hybrids and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than 7 million Americans, and representing approximately 20 percent of the PBGC's premium revenue.

Despite the significant value that hybrid plans deliver to employees, current legal uncertainties threaten their continued existence. As a result of one court decision, every employer that today sponsors a hybrid plan finds itself in potential legal jeopardy. It is critical that this uncertainty be remedied and pension reform legislation needs to clarify that the cash balance and pension equity designs satisfy current age discrimination rules.

In addition to clarifying the age appropriateness of the hybrid plan designs, we believe it is essential to provide legal certainty for the hybrid plan conversions that have already taken place. These conversions were pursued in good faith and in reliance on the legal authorities in place at the time. We also strongly urge you to reject specific benefit mandates when employers convert to hybrid pension plans. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans. Inflexible mandates will only drive employers from the system and reduce the competitiveness of American business.

*Conclusion*

We thank you for the opportunity to present our views. We all agree that reforms are needed. It is critical, however, that reforms revitalize and support, rather than undermine, the defined benefit pension system. In this respect, the Administration's funding proposal has a number of strengths. However, we are concerned that certain aspects of the Administration's proposal could harm plans, participants, companies, and the PBGC itself. We are committed to working with the Administration and the Congress to ensure that policies are adopted that will strengthen the PBGC and the defined benefit pension system.

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Chairman BOEHNER. Thank you.

Mr. Stein.

**STATEMENT OF NORMAN STEIN, DOUGLAS ARANT PROFESSOR, UNIVERSITY OF ALABAMA SCHOOL OF LAW, TUSCALOOSA, AL**

Mr. STEIN. Thank you, Mr. Chairman.

Whether the defined benefit system is in severe or only moderate financial distress is debatable, but there can be no honest discussion about that system without acknowledging that it faces serious challenges.

The administration's proposals to remake the system are serious and thoughtful. They reflect a particular take on how much financial risk society should bear with respect to defined benefit plans.

The administration's answer is, ultimately, not very much risk, and as such, it would radically reshape the defined benefit landscape, shifting substantial new financial burdens and risks on American businesses and their employees.

I want to talk today in my oral remarks about certain guiding principles that I think should be considered in discussion of funding rules and Pension Benefit Guaranty Corporation.

First, the funding rules must be reformed.

The funding rules must move away from allowing plan sponsors to create large, under-funded, but guaranteed liabilities, whether at the plan's creation or later through plan amendment improving benefits, and the funding rules should not permit plan sponsors to avoid responsible funding by positing a perpetually optimistic view about future investment performance or by using actuarial methods that protect plans from timely recognition of true economic loss.

Second, funding reform is a balancing act, for funding reform will dampen incentives for firms to sponsor defined benefit plans.

Funding reforms will reduce the attractiveness of defined benefit plans to plan sponsors.

They will reduce the plan sponsor's ability to minimize contribution in times of reduce corporate cash-flow. They will decrease the ability of plan sponsors to award past service benefits, to increase benefits in the future, or create early retirement windows.

They will increase cash-flow volatility unless plan sponsors invest in debt instruments that match plan liabilities, which many plan sponsors firmly believe will substantially increase the long-term costs of plan sponsorship.

Thus, the more fiscal discipline funding rules imposed on plan sponsors, the fewer the number of businesses that will choose to sponsor defined benefit plans.

This is simply a reality that should not paralyze, but should inform congressional consideration of how to improve the rules.

Third, existing employee expectation, benefit expectation, should be respected.

Especially in the short term, employee expectations formed under the current legal regime should be respected.

Thus, for example, broad and immediately effective restrictions on employees' access to certain types of benefits where the immediate negation of certain benefit guarantees were a mandatory freeze on new benefit accruals should be avoided wherever possible.

Fourth, create fiscally responsible regulatory options that permit employers and employees flexibility to preserve existing defined benefit plans.

There are situations in which our current legal regime is unnecessarily rigid and could be improved by allowing stakeholders in a pension plan, participants, sponsors, and the PBGC to negotiate agreements that would increase the possibility of saving a plan without adding additional financial burdens to the PBGC.

My written remarks describe a specific idea which in other presentations I've called a negotiated benefit, benefit guarantee freeze.

Reserve tax benefits for pension plan assets used for providing pensions.

The administration's proposals would permit plan sponsors to contribute and deduct larger plan contributions to plans than are currently permitted for the purpose of encouraging better plan funding. This is a laudatory goal, but it has tax costs.

Thus, such changes should require that pension contributions are used solely to provide pension benefits to participants in the plan and cannot be used for unrelated corporate purposes, and I don't completely agree with Secretary Combs' remarks that this doesn't happen in today's system.

And finally, as a society, we should accept some responsibility for the current financial problems in the defined benefit system.

We should not lose sight of a simple fact. The current fiscal stresses on defined benefit plans and the PBGC are not the product of illegal fraud committed by mendacious corporate managers, nor the selfish actions of the millions of Americans who relied on these plans.

Rather, the problems are, at least in retrospect, the results of laws that Congress enacted and of actions that the executive branch took.

Congress created a statutory scheme in which plan sponsors were told that they could create benefits and not fully fund them. Congress created a system in which employers have enjoyed great flexibility in managing—the administration says manipulating—annual contribution levels.

As Roy Kinsella told us in "Field of Dreams," if you build it, they will come. Well, Congress built this structure and corporate managers came, and did just what we would have expected rationally economic actors to do: they used the system to advance what they perceived to be the economic interests of their firm.

It would be deeply unjust, particularly to the employees who participate in those plans, to impose immediate, crippling new funding obligations on plan sponsors to remedy more than a quarter century of problems that developed under this defective regulatory scheme.

Such obligations will force the demise of many plans, bankrupt some employers, and ultimately punish employees who worked hard and played by the rules.

I would thus suggest as perhaps the most fundamental guiding principle the idea that we treat the problems with the statute as two separate problems:

First, what to do about existing liabilities that were created under the current rules; and second, how employers should fund new benefits in the future.

As to the latter problem, many of the administration's ideas are correct: require that new benefit promises be fully funded when made, that experienced losses be corrected more quickly than under current law, and that assets and liabilities be subject to more accurate economic measurement.

As to the former problem, already existing under-funded liabilities, I would suggest permitting those liabilities to be amortized over an extended period of time, but to address some of the more glaring flaws in the intersection of Title 4 of ERISA and the bankruptcy laws that hamper the PBGC's mission.

In other words, get funding rules right for benefit liabilities created tomorrow and forever thereafter, but be lenient with liabilities already created. To paraphrase Condaleeza Rice, an Alabama native, forgive yesterday's errors but punish tomorrow's sins.

[The prepared statement of Mr. Stein follows:]

**Statement of Norman P. Stein, Douglas Arant Professor, University of Alabama School of Law, Tuscaloosa, AL**

Mr. Chairman, Members of the Subcommittee, I am Norman Stein, a professor at the University of Alabama School of Law, where I am privileged to hold the Douglas Arant Professorship. I teach and write in the area of tax, labor and em-

ployee benefits. I thank you for the privilege of being able to share my views with you. My comments are my own and do not reflect the views of the University of Alabama, which I can, however, assure you has no views of its own on this subject.

Whether the defined benefit system is in severe or only moderate financial distress is debatable, but there can be no honest discussion about that system without acknowledging that it faces serious challenges. The Administration's proposals to remake the system are serious and thoughtful. They reflect a particular take on how much systemic financial risk plan participants, plan sponsors, and, ultimately, society should be asked to bear with respect to defined benefit plans. The Administration's answer is ultimately not very much risk and, as such, it would radically reshape the defined benefit landscape.

As my remarks will suggest, I do not fully agree with the Administration's answer—as reflected in its proposals—but in saying this, I should make two important preliminary observations: first, that there is no single right answer to this basic question of how much risk is acceptable; and second, that the system currently tolerates too much risk. It is ultimately for this Congress to determine how much risk is optimal. Congress's determination, however, will have profound implications for the future retirement income security of the millions of employees and retirees now participating in that system, the economic viability of the firms that sponsor them, and the long-term sustainability of the traditional defined benefit plan, which is the crown jewel of our private sector retirement system.

My written remarks are divided into two parts: first, I will argue for some guiding principles for addressing the problems facing the defined benefit system: these principles reflect my own views about how much risk we should be willing to tolerate to support the defined benefit system; second, I will offer some specific ideas that should, in my view, be part of the discussion, including some concerns with specific aspects of the Administration's proposals.

*I. Guiding Principles*

1. Funding Rules Must Be Reformed. Today's statutory regime invites inadequate funding of defined benefit plans and imposes too much risk on participants and society generally. The funding rules must move away from allowing plan sponsors to create large unfunded but guaranteed liabilities, whether at the plan's creation or later through plan amendment improving benefits. And the funding rules should not permit plan sponsors to avoid responsible funding by positing a perpetually optimistic view about future investment performance or by using actuarial methods that protect plans from timely recognition of investment and other experience losses.

2. Funding Reform Is a Balancing Act, for Funding Reform Will Dampen Incentives for Firms to Sponsor Defined Benefit Plans. Funding reforms will reduce the attractiveness of defined benefit plans to plan sponsors. They will reduce a plan sponsor's ability to minimize contributions in times of reduced cash flow. They will decrease the ability of plan sponsors to award past-service benefits, to increase benefits in the future or create early retirement windows. They will increase cash-flow volatility unless plan sponsors invest in debt instruments that match plan liabilities, which many plan sponsors argue would increase the long-term costs of plan sponsorship. Thus, the more fiscal discipline funding rules impose on plan sponsors, the fewer the number of businesses that will choose to continue to sponsor, or to adopt new, defined benefit plans. This is simply a reality, but a reality that should not paralyze Congressional will to improve the funding rules.

Ultimately, we will have to move to a world in which there are better funded, even if perhaps fewer, defined benefit plans. But with every measure Congress considers, it should ask whether the gain in fiscal discipline is sufficiently meaningful to dilute willingness to sponsor defined benefit plans. Where possible, we should want to encourage employers to continue to sponsor, and to adopt new, defined benefit plans. Thus, devising appropriate funding reforms requires a thoughtful balance of competing interests. We should certainly adopt no measure that reduces employer willingness to sponsor defined benefit plans unless the measure would produce demonstrable rather than theoretical gains in the financial security of plan benefits.

3. Existing Employee Expectations Benefit Expectations Should Be Respected. Especially in the short term, employee expectations formed under the current legal regime should be respected wherever possible. Thus, for example, broad and immediately effective restrictions on employee's access to certain types of benefits, or the immediate negation of certain benefit guarantees, or a mandatory freeze on new benefit accruals, should be avoided wherever possible.

4. Create Fiscally Responsible Regulatory Options That Permit Employers and Employees Flexibility To Preserve Existing Defined Benefit Plans. There are situations in which our current legal regime is unnecessarily rigid and could be improved by allowing stakeholders in a pension plan—participants, sponsors, and the PBGC—

to negotiate agreements that would increase the possibility of saving a plan without adding additional financial burdens to the PBGC. This might, for example, be accomplished by shifting some additional future risk from the PBGC to employees and shareholders instead of terminating a plan or imposing crushing immediate cash demands on the plan's sponsor. (I will discuss a specific idea—a negotiated guarantee freeze—in the next section.)

5. In Shaping Funding Reforms, Congress Should Reserve Tax Benefits for Regulatory Rules that Ensure that Pension Plan Assets are Used for Providing Pensions. Some changes favored by the Administration and private interest groups would permit plan sponsors to contribute and deduct larger plan contributions to plans than are currently permitted, for the purpose of encouraging better plan funding. This is a worthwhile goal, but it has tax costs. Thus, such changes should require that pension contributions are used to provide pension benefits to participants in the plan and cannot be used for unrelated corporate purposes.

6. As a Society, We Should Accept Some of the Responsibility for the Current Financial Problems in the Defined Benefit System. We should not lose sight of a simple fact: the current fiscal stresses on defined benefit plans and the PBGC are not the product of illegal fraud committed by mendacious corporate managers nor the selfish actions of the millions of Americans who have relied on defined benefit plans. Rather, the problems are, at least in retrospect, the results of the laws that Congress enacted and of actions taken by the Executive branch.

Congress created a statutory scheme in which plan sponsors were told that they could create benefits and not fully fund them for 30 years, even though PBGC guarantees were phased in over 5 years. Congress created a scheme in which plant shutdown benefits were insured even though they were rarely funded. Congress created a system in which employers have enjoyed great flexibility in managing—some might say manipulating—annual contribution levels and were protected from sudden and unpredictable changes in funding obligations through various actuarial smoothing methodologies.

As Roy Kinsella told us in Shoeless Joe, if you build it, they will come. Well Congress build this structure and corporate managers came and did just what we would have expected rationally economic actors to do: they used the system to advance the economic interests of the firm, its shareholders and employees. It would be unfair—particularly to the employees who participate in those plans—to impose immediate crippling new funding obligations on plan sponsors to remedy more than a quarter century of problems that developed under this defective regulatory scheme. Such obligations will force the demise of many plans, may bankrupt some employers, and ultimately will punish employees—who worked hard and played by the rules—with benefit and job losses.

Moreover, the worst of the problems of defined benefit plans are concentrated in a few industries that have undergone major structural change, partly in response to actions taken by the Federal government. The airline industry is a case in point. The pension promises that the traditional airline carriers made to their employees were reasonable when the pension plans were established. These carriers are, in my view, to be commended for trying to meet those promises to their employees, even after Congress ushered in deregulation and allowed discount airlines to compete on lower labor costs, benefiting the public but harming the traditional carriers and their employees. If the airline industry had not been deregulated, United, Delta, and U.S. Airways would have been better situated to fund their pension plans adequately. A similar story can, of course, be told about how changes in global trade has harmed the steel industry.

I would thus suggest as perhaps the most fundamental guiding principle the idea that we treat the problems with the statute as two separate problems: first, what to do about existing liabilities that were created under the current funding rules; and second, how employers should fund new benefits in the future. As to the latter problem, I think many of the administration's ideas are correct: require that new benefit promises be fully funded when made, that experience losses be corrected more much quickly than under current law, and that assets and liabilities are subject to more accurate economic measurement.

As to the former problem—already existing unfunded liabilities—I would suggest permitting those liabilities to be amortized over an extended period of time, but to address some of the glaring flaws in the intersection of Title IV of ERISA and the bankruptcy laws that hamper the PBGC's mission.

In other words, get funding rules right for benefit liabilities created tomorrow and forever thereafter, but be lenient with liabilities already created. Forgive yesterday's errors but punish tomorrow's.

*II. Specific Ideas*

I offer the following specific ideas:

*Funding of Plans and Limitations on Benefits*

1. The Corporate Bond Rate Understates True Pension Liabilities. The Department of Treasury has suggested that the interest rate for discounting plan liabilities be changed permanently from the 30-year treasury rate to long-term corporate bond rates. The result of this change is less rather than more plan funding, an odd position for the Department of Treasury to take. In addition, the corporate bond rate lacks adequate conceptual justification: such rates are higher than the discount rate that would be used by an insurance company in valuing a plan's liabilities and the corporate bond market is thin, particularly with respect to bonds with long durations. Moreover, corporate bond rates are subject to risk, although Title IV purports to make payment of benefits riskless to participants up to PBGC guarantee levels. The appropriate discount rate should therefore be pegged to riskless, or nearly riskless, instruments, such as government-issued bonds.

2. The Yield Curve. The Administration has proposed that plan liabilities be discounted to present value using a yield curve derived from interest rates on high-quality corporate obligations. For some plans, such a yield curve may actually reduce funding obligations, which we think is counter-productive to the Administration's purported goal of improving plan funding; for other plans—those with a mature workforce and many retirees, a yield curve would substantially increase funding and perhaps force bankruptcies and create job loss in important sectors of our economy.

These economic consequences to firms and their employees should not be ignored in the funding debate. And I would also argue that changes to the funding rules that will add new financial stresses to challenged sectors of the economy must not be made in a funding vacuum: some changes—for example, mortality tables tailored to reflect the shorter life expectancies of employees in some industries and in some mature plans—should be considered as part of the same funding debate, of which the proper discount rate is but one part.

Also, if a yield curve is to be used, it might be advisable to exempt smaller plans, for whom the increased accuracy in liability measurement might not justify the complexity and expense of compliance.

3. Adjusting the Full–Funding Limitation. The Administration proposal would increase the full funding limitation, permitting plan sponsors to make larger contributions in "good" years, which would then reduce contribution obligations in less profitable or loss years. I am skeptical that this would do much to improve the funding of at-risk plans, since increased contributions would primarily be made by the strongest firms, which would have an interest in using the plan's tax-exempt status to favorably fund future payroll costs. Nevertheless, the only harm to increasing maximum contribution obligations is loss of potential tax revenue—tax revenue that might be better spent to shore up the PBGC directly.

In any event, if profitable firms are going to be able to enjoy the substantial tax advantages of aggressively overfunding their pension plans, it is important that the funding be irrevocably committed to providing pension benefits for the participants in the pension plan. Despite the reversion tax, employers have found numerous ways of using the surplus in an ongoing plan for general corporate purposes. (Some of these practices were documented in a 2003 story in the Wall Street Journal.) When a plan is overfunded, the assets in excess of the present value of plan liabilities should be regarded as a rainy-day fund for harder economic times, which the business cycles of a market-driven economy ensure will recur. Thus, an increase in the contribution limits should include new restrictions on how excess plan assets can be used.

4. The Role of Firm Creditworthiness. The Administration's proposal would calculate plan liabilities differently for firms with debt ratings below investment grade. The effects of this calculation would include increased plan contributions and limits on a participant's right to a lump sum distribution.

There are some important issues that should be addressed in the Administration's proposals, the most fundamental of which is whether the government should be using credit scores from unregulated and sometimes conflicted ratings agencies to help measure contribution obligations or to restrict participant access to certain benefit forms. But the Administration's proposals, as they stand, have some details that need to be thought through. For example, a firm with a below-investment grade rating would for funding purposes assume a greater incidence of lump sum payouts, even though other parts of the Administration's proposal might limit the availability of such payouts to participants in such plans. And the Administration's proposals treat employees whose debt was just recently reduced below investment grade more

leniently than companies who have had such a rating for a longer period of time. If a company is rated as a serious credit risk, it is a serious risk no matter how long it has had such status. The proposal does not explain why different treatment is appropriate, except as a phase-in.

More fundamentally, if a firm's creditworthiness is a valid consideration under ERISA (and I lean toward the view that it is), a perhaps better use for credit ratings would be to reward high levels of creditworthiness rather than merely penalize low levels: I would consider allowing firms with high credit ratings to use actuarial smoothing methods and more flexibility with respect to actuarial assumptions, if they choose, to reduce volatility in contribution obligations.

5. Freeze on Benefit Accruals. The Administration proposal would require that certain underfunded plans freeze future benefit accruals and would bar benefit improvements. Such restrictions are wrong, so long as new benefits are fully funded and old benefit liabilities are being amortized under appropriately rigorous schedules.

6. Restrictions on Lump Sums. Many participants have relied upon the availability of lump sum payments. The Administration's proposal is correct that such payments can drain plan assets and can allow some employees to take benefits that will, ultimately, prove to be larger than the PBGC guaranteed benefits that the participant would have received had the plan terminated. An intermediate position, which better recognizes the expectations of employees, would be to permit payment of partial lump sums with a reduced annuity benefit. Moreover, if an underfunded plan is brought up to adequate funding, employees who were forced to take an annuity should be permitted—with perhaps certain limitations—to take a lump sum benefit equal to the present value of remaining annuity payments.

7. Changes in Interest Rates for Lump Sum Benefits. Many pension plans provide participants with the opportunity to elect to receive their benefits as single sum amounts, and most pension plans actually force participants to take lump sums if the value of their benefit is less than $5,000. In determining the value of the benefit, and hence single-sum amount the participant will receive, the Internal Revenue Code requires that the plan use an interest factor equal to interest on a 30-year treasury bond. Some trade groups and employers, and the Administration, argue that plan solvency would be helped if the discount rate were changed to corporate bond rates, which would have the effect of substantially reducing the value of such single-sum payments.

While I am not an advocate of lump sum distribution options, it also seems plain to me that once a firm promises an employee a benefit, it should not be able to break that promise. Employees view pension plans as contracts and the interest rate used for valuing lump sums is a part of those contracts. Those who would change the interest rates are, in effect, asking Congress to relieve them of a bargain they made with their workers.

Some who argue for reducing lump sum benefits argue that it is unfair that employees are choosing lump sums because they are economically more valuable than annuity benefits. But since when in our economic system is it wrong for people to choose the most advantageous contractual option available to them? Moreover, when an employee elects a lump sum benefit, the employee loses the insurance protection provided by the PBGC, which itself has economic value. And we doubt that most working people will be able to realize a rate of return equal to the interest rate on corporate bonds, at least without exposing themselves to substantial market risk. In addition, the plan saves substantial administrative costs when it cashes out small benefits that often exceed the actual present value of the benefits to the employee. Finally, in some cases, employees choose lump sums not as a wealth maximizing strategy, but simply because they do not trust their former employer with their money. Indeed, in many cases where a plan offers a subsidized early retirement benefit, the lump sum—even with its value being determined with a discount rate equal to the interest rate on a 30-year treasury obligation—can exclude the subsidy and thus be worth substantially less than the annuity benefit. Yet many workers nevertheless select the less valuable lump sum.

Whatever the merit of the argument for allowing employers to break their contractual obligations to people who have a choice of whether to take a lump sum or annuity benefit, there is no reasonable argument that we should reduce lump sums for workers when their employers "force" them to take lump sums. Such workers, because of the small amounts they receive (less than $5,000), will have limited investment opportunities and will not be able to achieve a rate of return equal to the corporate bond rate. In addition, empirical research shows that the larger the lump sum, the more likely it is that an employee will save some of it for retirement by rolling it over into an IRA. Reducing the amount of the lump sum for these employees will thus contribute to asset leakage from the retirement system. Finally, in-

creasing the interest rate will increase the number of employees who will be forced to take a lump sum, for a larger number of annuity benefits would have a present value of less than $5,000.

*Plan Terminations and Title IV of ERISA*

8. Variable Premium Increases . The Administration's proposal contemplates substantial increases in the variable premium paid by seriously underfunded plans. This will put more financial stress on already stressed firms, making it harder for them to shore up the funding of their own plans. A better approach would be for a portion of the variable premium to be paid to the plan, in addition to its ordinary contribution, Such payments could be segregated in a separate fund and if the plan ultimately terminates, the fund could be allocated entirely to guaranteed benefits.

9. Use of General Revenues. There might be periodic or episodic appropriations to the PBGC from general revenues (which might be paid for by a partial rollback of the recent increases in IRC Section 415 and elective contribution limits, which have reduced taxes for the wealthiest individuals while doing little to improve retirement security for average American workers). Such appropriations are, I believe, justifiable, since as I have already observed, Congress and the Federal government bear some responsibility for the funding challenges the system now faces.

Moreover, the PBGC serves not only an insurance function, but also a social insurance function. Currently, firms with low-risk defined benefit plans fund the social-insurance mission of the PBGC by paying premiums that are larger than needed to cover the actual risk of their plans terminating with insufficient assets. In effect, this is a tax on such firms. It might be fairer to shift part of this burden to a wider universe of taxpayers.

10. Impose an Exit Charge on Employers Who Leave the Defined Benefit System. To prevent flight of healthy firms from the defined benefit system, an exit charge (or withdrawal liability) might be imposed on employers who voluntarily terminate their defined benefit plans. When they leave the system, they saddle a larger portion of the PBGC's unfunded liabilities on the employers who remain behind; in effect, the system currently rewards those who desert the system by relieving them of future premium responsibility.

11. Impose a Small PBGC Charge on Sponsors of Defined Contribution Plans. As I just noted, a portion of the cost of subsidizing failing defined benefit plans is born by sponsors of healthy defined benefit plans. Congress might consider imposing on sponsors of defined contribution plans (who do not also sponsor defined benefit plans) a small charge so that this cost is shared by sponsors of all tax-subsidized plans.

12. Plant Shutdown Benefits. The Administration proposal would immediately cancel PBGC guarantees for plant shutdown benefits and beginning in 2006 would prohibit pension plans from offering such benefits. Both of these ideas are ill-advised.

Plant shutdown benefits are critical benefits for employees at a time when they are subject to particularly harsh economic dislocations. Those benefits are currently insured and to suddenly end those guarantees without a transition period would be to break faith with some of the nation's most vulnerable workers.

An alternative to prohibiting a pension plan from offering plant shutdown benefits might be to create a separate insurance program for such benefits, with a risk-based premium. This idea should at least be explored.

13. Negotiated Benefit Guarantee Freezes. Under current law, there are two options open to an employer contemplating a voluntary termination or to the PBGC contemplating an involuntary termination: go ahead and terminate the plan or continue the plan (with or without a benefit freeze). If the plan is terminated, the employees lose not only future benefit accruals, but also the amount by which their benefits exceed the PBGC guaranteed benefits. But if the plan does not terminate, the employer's funding obligations continue unabated at a time when such contributions might force the employer out of business and the PBGC's potential liabilities continue to grow. It should be possible for the plan sponsor, the employees (through either their collective bargaining representative or an elected committee if the employees are not represented), and the PBGC to negotiate alternatives to the two stark and often unsatisfactory choices now available.

Under a negotiated agreement, the PBGC would be protected from additional liabilities by freezing benefit guarantees and Title IV asset allocations as of the date of the agreement. The agreement might allow the employer to temporarily reduce its funding obligations and might allow the continuation of benefit accruals, so long as employees understood that new benefits would not be guaranteed unless the plan is ultimately fully funded.. Such agreements, which could be tailored to particular situations and should be limited in duration, would harm no stakeholder and would

offer potential benefit to all stakeholders. It is an idea that merits discussion, especially for situations where the employer is undergoing reorganization proceedings.

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

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Chairman BOEHNER. Thank you, Mr. Stein.

Dr. Mulvey.

**STATEMENT OF JANEMARIE MULVEY, CHIEF ECONOMIST, EMPLOYMENT POLICY FOUNDATION, WASHINGTON, DC**

Ms. MULVEY. Good morning, Chairman Boehner, Ranking Member Miller, and Members of the Committee. Thank you for the opportunity to appear before you today.

This hearing comes at a crucial time, and I would like to commend the Bush Administration for introducing a pension reform proposal for Congress to consider.

The majority of large employers have been voluntarily providing pension coverage for many years, and they recognize the importance of this coverage to the retirement security of their workers, yet plan sponsors face increased pressure from regulatory, economic, and demographic forces.

Since the mid-1980's inflation-adjusted administrative costs have more than doubled. More recently, declining equity and interest rates have eroded their pension assets.

And finally, attempts by firms to establish hybrid pension plans to meet the needs of a more mobile workforce have faced legal challenges.

The combination of these forces have prompted many plan sponsors to reevaluate the cost effectiveness of continuing to offer a defined benefit plan.

The two stated goals of the administration proposal are to protect workers and to avoid a taxpayer bailout.

A third goal should also be considered. That is, pension reforms should be evaluated relative to their ultimate cost impact for healthy plan sponsors. Any reform should not compromise their ability to afford these plans in the future.

Having said this, there are both positive and negative aspects of the administration proposal.

On the positive side, the administration proposes to increase the current funding limit, would allow firms to increase funding during good times and provide a buffer for recessionary periods.

The administration proposal would also consolidate the accounting and actuarial measures, thereby reducing some of the administrative burden on plan sponsors. However, the ultimate measure agreed upon must carefully consider its impact on plan sponsors and overall plan funding.

For example, the administration proposes the use of a spot rate for determining pension liabilities to replace the current practice of a 4-year weighted average. The use of a spot rate could increase the volatility of pension liabilities, especially during steep economic cycles.

Further, the administration proposes the use of a more complex yield curve to estimate pension liabilities. Those industries with an older than average workforce would be most adversely affected by

the use of a yield curve, specifically the manufacturing, transportation, utilities, and communications sectors.

These costs will further be exacerbated by the proposed increase in PBGC premiums. While premium increases appear inherently small, they will also be borne predominantly by the manufacturing industry, an industry that is still recovering from the earlier economic downturn.

The release of the administration's proposal underscores the high level of interest in the Bush Administration to preserve the DB pension system for workers and improve its future solvency, which is commendable. However, in doing so, policymakers should consider whether the reforms being considered would lead to increased pension costs of healthy companies and whether those increased costs would seriously compromise ability to afford the plans.

In addition, policymakers should give careful consideration to whether the reforms unduly restrict hybrid plan conversions, or impose strict mandates such as requiring choice or grandfathering for all current workers.

Both the administration and Congress must recognize that employer-provided retirement benefits are voluntary. If pension reforms were to impose additional and unnecessary costs on already healthy plans, policymakers should ask whether these changes would ultimately force many to exit the system altogether and substitute a defined contribution plan.

Ironically, if that were to occur, as more firms exited the system amidst rising costs, the available pool for PBGC premiums would eventually decline. Obviously, such an outcome would defeat the intent of the administration's proposal, which was to help preserve the DB pension system in the first place.

Thank you for the opportunity to present my views, and I would be glad to answer any questions.

[The prepared statement of Ms. Mulvey follows:]

**Statement of Janemarie Mulvey, Ph.D., Chief Economist, Employment Policy Foundation, Washington, DC**

Chairman Boehner, Ranking Member Miller and members of the committee, thank you for the opportunity to appear before you today. My name is Janemarie Mulvey, and I serve as Chief Economist of the Employment Policy Foundation (EPF). EPF is a research and educational foundation founded in 1983 that focuses on workforce trends and policies. This hearing on pension reform comes at a crucial time. Currently, the defined benefit pension system continues to face increased pressure from regulatory, economic and demographic forces. Since the mid–1980s, increased regulatory and compliance requirements have more than doubled the administrative costs of plan sponsors.[1] More recently, declining equities and interest rates have reduced the asset values of corporate pensions, forcing many plan sponsors to increase their funding contributions during the recent economic recession. At the same time, bankruptcies in the steel and airline industries have left the major insurer of private pensions—the Pension Benefit Guarantee Corporation (PBGC)—with a $23 billion deficit. Finally, attempts by firms to redesign their traditional defined benefits plans to meet the needs of a more mobile workforce have faced legal challenges. Given these pressures, plan sponsors are re-evaluating the cost-effectiveness of offering a defined benefit (DB) plan to their employees.

We commend the Bush Administration for putting forth a pension reform proposal to begin to address some of these issues. As you know, the Administration proposal addresses three key areas:

[1] Hustead, Edwin C. 1998 "Trends in Plan Administration," in Living With Defined Contribution Pensions ed. Olivia Mitchell and Sylvester J. Schieber, The Pension Research Council Wharton School, University of Pennsylvania.

- Reforming funding rules;
- Reforming insurance premiums; and
- Improving disclosure.

While the Administration proposal represents an important step toward reforming our nation's pension system, there are some areas of which the proposal warrants serious discussion. My testimony will highlight those key areas and their potential implications for plan sponsors.

*Reform Funding Rules*

The Administration proposes changes to the pension funding rules in three key areas:

- Consolidate the accounting and actuarial measures;
- Tie pension valuations to a yield curve; and
- Increase the funding limit.

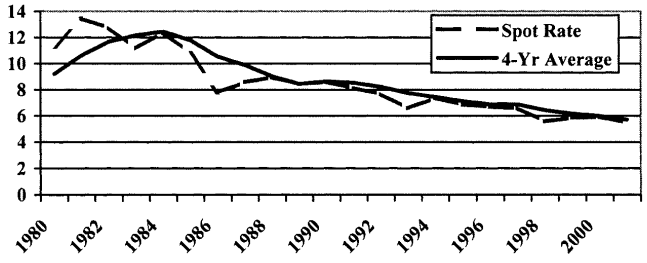
*Consolidate the Accounting and Actuarial Measures*

The actuarial calculation of pension liabilities for funding purposes is no doubt complicated and depends on a number of assumptions about interest rates, mortality, and other factors. Furthermore, these actuarial estimates are not consistent with those reported on a firm's financial disclosure form. The Administration proposes to make the actuarial and accounting rules more consistent. On the plus side, moving to one consistent measure of pension liabilities could reduce the administrative complexity and avoid computing two distinct measures—one for accounting purposes and one for funding purposes. However, beyond the administrative savings that might occur, the ultimate impact on plan sponsor's balance sheets will depend on the details of the eventual formula and assumptions that evolve from the upcoming debate.

*Tie Pension Valuations to a Yield Curve*

The Administration has proposed some major changes in the interest rate used when employers value their pension plans. This change may adversely affect plan sponsor's reported pension liabilities. Currently, plan sponsors rely on a four-year weighted average of a long-term bond rate. The Administration proposes that plan sponsors use a "spot" rate rather than a four-year weighted average. While interest rates have been less volatile in recent years, these rates diverged considerably in the late 1980's (see Figure 1). Thus, the use of a spot rate could increase the volatility of pension liabilities during certain periods and raise required contributions above a level that might not be necessary when viewed over the longer-time period. This volatility also would make it more challenging for firms to develop reliable long-term financial and/or strategic plans for their company.

**Figure 1: Comparison of Spot Rate Vs. Weighted Average 30-Year Bond Rate**




*EPF Analysis of data from the Department of Treasury, Board of Governors of the Federal Reserv*

The Administration also proposes that firms use a more complex yield curve to better align pension liabilities with their expected duration. Under the proposal, firms must discount future pension liabilities using a short-term interest rate for older workers near retirement and a long-term interest rate for younger workers who are still many years from retirement. By tying these liabilities to a yield curve, an EPF analysis shows that under the current interest rate environment, plan sponsors could experience a 3.5 percent increase in calculated pension liabilities for workers ages 55 and older and a 2.0 percent increase for workers ages 50 to 54. This could disproportionately affect firms that have a higher share of older workers.

Specifically, the manufacturing, transportation, utilities and communications industry could be hardest hit by the proposed change.

*Increase the Funding Limit*

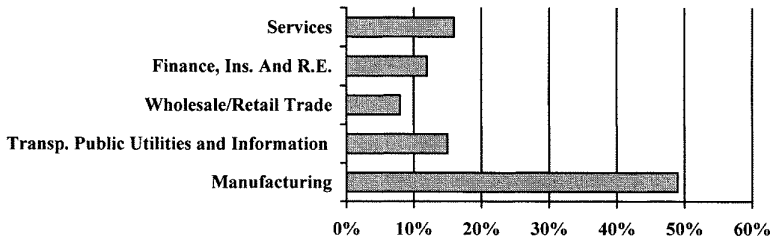
The Administration also proposes raising the current limit on the amount a firm can fund on a tax-qualified basis. This limit has prohibited plan sponsors from making additional tax-qualified contributions when profits were rising. Thus, during the recent recession, when their asset values were falling, firms had to increase their contribution rates at a time when they were less likely able to afford to do so. The Administration proposal would allow firms to fund up to 130 percent of this limit and would index future increases to growth in wages rather than consumer prices. This would positively impact firm's ability to pre-fund their pension liabilities, especially during upturns in the business cycle.

*Reform Insurance Premiums*

The Employer Retirement Income Security Act established the PBGC in 1974 to insure the private-sector DB pension participants against default. Over the past few years, the financial viability of the program has come into question prompted by some well-publicized bankruptcies. According to the PBGC, since 1975, the firms representing the ten largest claims have accounted for more than sixty percent of all claims against the PGBC.[2] These claims have been concentrated in two major industry groups—steel and airlines. Furthermore, over the past few years, claims paid for two major firms—one steel and one airline—have reached historical highs. In 2003, the PBGC took over $3.7 billion in claims for unfunded pension liabilities from a large steel company. At the time, this was the highest claim ever paid by the PBGC. More recently, claims by a major airline are expected to surpass this earlier claim, and are expected to top $7.5 billion. As a result of the bankruptcies of only a few companies, the PBGC reported a deficit of $23 billion in 2004. To close the PBGC's budget shortfall, the Administration proposes to raise the fixed rate premium from $19 to $30 per participant and to tie future premium increases to wage growth. Their rationale for this proposed increase is that PBGC premiums have not risen since 1991. While $11 per participant appears like a small increase in absolute terms, in percentage terms it represents a 58% increase. For very large firms, these dollars can certainly add up quickly.

More importantly, since the majority of pension plan participants are in the manufacturing sector, an EPF analysis estimates that manufacturers, which comprise over 16 million pension plan participants, will pay $178 million more in premiums under the Administration proposal. This represents 49% of all proposed premium increases (see Figure 2). These costs will be further compounded for manufacturers with an older than average workforce who would be funding their plans at higher rates if pension liabilities are tied to the yield curve, as discussed above. These additional costs would be imposed on an industry that is still trying to rebound from declining profitability in some key sectors like computers, electronic products and motor vehicles.[3]

**Figure 2: Share of Proposed PBGC Premium Increases Under Administration Reform Proposal By Industry**




*Source: Employment Policy Foundation Analysis of PBGC Data*

[2] Pension Benefit Guaranty Corporation, Pension Insurance Data Book, 2003.

[3] U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 6.16D.

*Change the Structure of Variable Rate Premiums*

In addition to raising the fixed rate premiums, the Administration proposes to change the structure of variable rate premiums to better reflect the default risk of under- funded plans. Currently, employers with under-funded plans pay an additional premium of $9 per participant for each $1,000 that their plan is under-funded. Under the Administration's proposal a risk-based premium will be charged to each plan that is under-funded relative to its funding target based on the percentage of the shortfall. Furthermore, firms in the at-risk category will not be allowed to raise the generosity of their benefits, preventing them from over-promising benefits that they may not be able to pay in the future. The specific details of the calculation of the risk-based premium are not yet available. From a fairness perspective, the proposal does try to increase the premium burden for at-risk plans versus those not at-risk. However, it will be important that the definition of at-risk is clearly defined and represents an accurate depiction of a firm's financial state. To do this, reform measures should take into account the possibility of short-term volatility in a plan sponsor's financial situation.

*Improve Disclosure*

The Administration also proposes to improve both the content and timeliness of the disclosure of pension liabilities. For workers and retirees, this information will provide them a better measure of the security of pensions in the future. For regulators, these efforts will allow them to improve their evaluation of plan sponsors' financial obligations and potential risk of default in the future. Specifically, the Administration proposes to:

- Improve disclosure of plan funding status and funding trends;
- Make publicly available certain information filed with the PBGC by under-funded plans; and
- Provide for more timely reporting and limits on filing extensions of plan annual reports.

Again, the details of the timing of increased disclosures and other facets of this part of the proposal have not been developed, so it is difficult to evaluate the implications on plan sponsors at this point in time. But generally, as noted earlier, any changes proposed should attempt to reduce—rather than increase—the administrative burden of plan sponsors.

*Hybrid Pension Plans*

In releasing their pension reform proposal, the Administration also said it would soon support a hybrid plan proposal, which could resolve some of the legal challenges surrounding the cash balance debate. However, their current hybrid proposal still includes a five-year hold harmless provision that would certainly discourage plan sponsors from transitioning to a hybrid plan. It is important that any reforms recognize that most plan sponsors have implemented hybrid plans to meet the needs of a more mobile workforce and not necessarily to reduce their pension expenses. Today's workers seek more portable yet guaranteed benefits, which hybrid plans provide.

*Conclusion*

The release of this proposal underscores the high level of interest the Bush Administration has in preserving the DB pension system and improving its future solvency, but many of the proposal's implications for plan sponsors will not be evident until the actual details are worked out in Congress and in the regulatory process. In the end, pension reforms should not lead to increased pension costs of "healthy" companies that would seriously compromise their ability to afford these plans in the future; nor should policymakers unduly restrict hybrid plan conversions or impose strict mandates such as requiring choice or grandfathering for all current workers. Both the Administration and Congress must recognize that employer-provided retirement benefits are voluntary. If pension reforms were to impose additional and unnecessary costs on plan sponsors, this could ultimately force many plan sponsors to reconsider offering DB plans altogether and substitute a defined contribution plan that is portable and has much lower administrative costs. This is an outcome many future retirees would not see as desirable. Ironically, as more firms exit the system amidst rising costs, the available pool for PBGC revenues would eventually decline. Obviously, these outcomes would defeat the intent of the Administration's proposal, which was to help preserve the DB pension system.

Thank you for the opportunity to present my views. I would be glad to answer any questions you may have.

Chairman BOEHNER. I thank the witnesses for your testimony.

I think each of you to some extent or the other talked about the balancing act that the administration was involved in, and the balancing act that the Congress will be involved in, in terms of trying to preserve the defined benefit system while at the same time ensure that plan sponsors are making the contributions that, or keeping the commitments, if you will, that they've made to their workers.

Mr. Stein, you talked about these negotiated agreements for difficult situations, where employers, employees, and the PBGC would sit down and come to some agreement.

Do you want to explain that in more detail?

Mr. STEIN. Yes, and I should also mention that there was an opinion column in the Wall Street Journal about a month or two ago which former PBGC executive director Kanderian wrote with, I think it was both the pilot and the chief executive officer of Delta, which is similar to what I was suggesting.

When a company is in bankruptcy, the employer wants to be able to contribute less immediately because it has cash-flow obligations.

The employees would like to see the plans continue and the PBGC doesn't want to see its obligations potentially increase, and it would be possible, by freezing benefits, by freezing the PBGC's obligations, to allow some kind of short-term period in which benefits would continue to accrue but would not be guaranteed. So long as the employees know that, the employer might be allowed not perhaps a complete contribution holiday, but could reduce its contributions.

And in doing that, I think all three stakeholders would be better off and, under the current system, you can't do that. It's either terminate the plan or keep it going.

Chairman BOEHNER. Let me ask a few questions about this.

One is, why wait 'til they get to bankruptcy? Some would argue that the DRC requirements under the current rules are actually forcing some into bankruptcy in order to discharge their responsibility.

And second, if you were to allow this type of negotiated agreement, what kind of an amortization period would you think is reasonable?

Mr. STEIN. I'm not going to be very good on the details right now.

I did, in my written testimony, say that this is something that might be used also outside of bankruptcy, so I agree with you there.

Just right now, the employer and PBGC have a stark choice: terminate the plan, transfer liabilities to the PBGC, or continue the plan, which is often not viable for the employer if it has to continue with a DRC.

Chairman BOEHNER. Mr. Porter, in your testimony, you state that the smoothing of assets and interest rates is crucial for employers.

However, I think you realize that the administration's proposal recommends smoothing contributions.

Can you explain why you recommend smoothing assets and interest rates instead of contributions?

Mr. PORTER. The funded status of a plan over the very long term can be affected very dramatically by short-term changes in interest rates. History tells us that fluctuations in interest rates may or may not reflect what the market is. It reflects whatever happens to be going on at that point in time in the economy.

Rapid changes in funded status just because there's a change in the economy that is abrupt changes the perception and immediately changes what the contribution perhaps might be.

Let me give you an example.

If there was a huge shock to the economy of some sort that changed dramatically the interest rates for 1 year, and the next year they were back to normal, smoothing would allow you to say, "OK, well, that's there 1-year blip and we won't make an egregious change simply because there's a 1-year blip," but over time, you would recognize that if that blip became permanent, it is then fully recognized.

The administration's proposal says, "We're going to take that moment blip, momentary blip, and record it as if it's real."

Chairman BOEHNER. But the fact is that the discount rate that's been used for the last 25 years has been the 30-year bond.

Mr. PORTER. Actually, that's partially true.

If you go back prior to about the mid-1990's, most companies, the long-term bond didn't apply. If you're a final pay pension plan, as many of our plans are, the long-term funding assumptions actually produced better funding than the 30-year bond current minimum that is applied.

The current liability did not apply to most large final pay plans until just recent years.

Chairman BOEHNER. In your testimony, you state that credit balances are not adjusted for market performance.

Mr. PORTER. Right.

Chairman BOEHNER. And I guess the question I've got is, should credit balances reflect market gains and/or losses?

Mr. PORTER. That's a difficult policy decision. Certainly during the years of 2000 through 2002, a lot of critics have indicated that credit balances should have been reduced. There have been other years when interest rates were very high.

You need to have some parallel treatment. Either it's going to increase and reduce with market value or increase and reduce with underlying assumption of some sort, but it could work both ways.

You could actually have some credit balances that would be higher today and some that would be lower if they were market adjusted. It would just be different.

Chairman BOEHNER. The Chair recognizes the gentleman from Michigan, Mr. Kildee.

Mr. KILDEE. Thank you, Mr. Chairman.

Professor Stein, you mentioned two categories, liabilities already existing for terminated plans, and new liabilities.

How would you suggest we pay for those existing liabilities for terminated plans?

Mr. STEIN. Well, I'm going to say something which I don't think is very popular, and I don't think many Members of this Committee probably agree with right now, but I think that as I suggested, I think part of the problem that we're experiencing now is

a problem that we as a society caused, and it wasn't simply the defective funding schemes.

I think one of the earlier questions to the first panel suggested that a lot of this was industry specific and in fact some of the problems industries are facing reflect deliberate decisions that we as a nation made, decisions I think which have been on the whole positive, but which have affected certain industries very harshly.

The airlines would be one example. We deregulated the airlines. We allowed discount carriers to come in that did not have defined benefit plans, paid much lower salaries to their employees, and created—the promises that the airline industries made to their employees were quite reasonable when made, and I think the airlines are to be commended for trying to meet those promises for so long, but ultimately the decisions we made to deregulate, which we as consumers have enjoyed, have hurt those industries and are one of the causes of the problems that they're now experiencing.

So I think, you know I mean, I would like—you know, I have faith that if the economy improves, the PBGC's current crisis will not be quite as severe as it appears right now. I think there are some things which suggest that the situation in the PBGC is not quite as bad as the government, the administration is presenting it.

I think if the economy improves, things will be again somewhat better, but ultimately I think—and this is where I think what I'm saying is not something that's politically easy—I think ultimately, if there are some problems like the savings and loan association, maybe this is something where the taxpayers should stand behind the laws which Congress created and have been on the books for so long.

Mr. KILDEE. In other words, where there may be a governmental cause, maybe there should be a governmental solution?

Mr. STEIN. Mm-hmm.

Mr. KILDEE. For example, deregulation was a governmental factor—

Mr. STEIN. Yeah, that's also—

Mr. KILDEE [continuing]. Policies would be governmental.

Mr. STEIN. Yes, that's also—somebody had—some actuaries and financial economists have talked about, rather than just amortizing the former liabilities, the under-funded liabilities over an extended period of time, that maybe it would be possible for the government to ensure loans to plans that would be made through the private sector and would make the plans whole now, and those loans would be paid off, subject to government guarantees.

I haven't really decided whether I think that's a good or bad idea but it's an interesting concept.

Mr. KILDEE. Does anyone else on the panel have any suggestions on that, or comments?

[No response.]

Mr. KILDEE. OK. Thank you very much, Professor Stein.

Mr. KLINE [presiding]. I thank the gentleman.

The gentleman from Georgia, Mr. Price, is recognized for 5 minutes.

Mr. PRICE. Thank you, Mr. Chairman.

I, too, appreciate the panel's perspective. I'm interested in revisiting Ms. Combs' comments in response to my question about whether or not the administration's proposal addresses the concerns that they and that we have, particularly as it relates to oversight.

Would any of you comment please on whether or not you believe that the proposals that have been put forward allow for appropriate oversight so that we don't end up right back here in 10 or 15 years with the same situation—not the solution, but the oversight?

Mr. PORTER. It's not clear to me, from the administration's proposals, as to what the oversight would be.

There are certain changes in how funding would take place and how participants would be disclosed, but as far as what the oversight of the administration would be, I don't believe there's anything overt in the proposal that would speak to that.

Mr. PRICE. Mr. Stein, do you have any comment?

Mr. STEIN. Well, there's one aspect in particular where I think oversight is going to be taken away, which is in the setting of premiums, and I've heard people complain. I think it's reasonable for people to say you can't just give that authority to PBGC, that there really has to be congressional oversight over that.

And, you know, this is not a competitive insurance market where there are lots of people competing against PBGC. PBGC has a monopoly in a sense, and you don't want to give them complete authority to set whatever rights they think are appropriate.

So there in particular I'm sympathetic to PBGC's need for more revenue, but I don't think giving PBGC both executive and legislative authority is prudent.

Mr. PRICE. Dr. Mulvey?

Ms. MULVEY. I think one of the problems is they're trying to handle a handful of plans, the unhealthy plans, and they're kind of penalizing all the healthy ones, so again, I don't agree whether they're plan does try to do the oversight properly.

Mr. PORTER. If you would allow me, I'd just like to follow on Mr. Stein's comment.

Under ERISA, there's only two ways that PBGC can fund its deficit. One is through premiums to employers, and the second is through investment return.

Recently, the PBGC chose to significantly change its investment portfolio to be much more conservative so their assets and liabilities would stay in line.

However, the expense of that was they permanently were to forego the extra yield that could have come from a better investment policy. That becomes higher premiums to plan participants.

It seems inappropriate in our view to vest the same agency with investment policy and premium oversight.

Mr. PRICE. OK. I want to step back again a little bit and maybe be heretical, and try to determine what the fundamental problem with all of this is, and I want to just ask whether or not any of you believe that the fundamental problem is the defined benefit program itself.

Mr. STEIN. The defined benefit system has been around for a very long period of time.

We went from a pay-as-you-go system basically, you know, when the first defined benefit plans were developed in the late 19th century.

Some of those plans experienced really substantial difficulty as the workforce aged and when the Great Depression came, but the system itself has been healthy, I think, and you know, its survival, its ability to pay benefits to millions of Americans suggests that there are problems, but they're not fundamental problems.

One of the concerns that I have about the administration's proposal is its effect on the healthy employers, which Dr. Mulvey just referred to.

And I'm not sure, I've been trying to think about this for the last several months, whether it's appropriate for the government to consider creditworthiness, but if it is appropriate to consider creditworthiness, certainly companies like DuPont should be, if they think it fits their business model better to be under the old rules, we're not worried about DuPont dumping its plan on the PBGC.

So if creditworthiness is going to be an operative factor in the statute, I would like to see it work both ways so that the firms that we really know are going to be around for the next 75 years and are going to stand behind their promises don't have to go to this radical new funding system if they don't want. I mean, they could. Obviously, you know, they have choices.

Mr. PORTER. Just a quick add-on. Our defined benefit plan, our principal one for the parent company in the U.S. celebrated its 100th birthday last year. I don't think it's the program. We've managed to fund that and keep it healthy for many, many years.

Thank you.

Ms. MULVEY. I would concur with that. I think the problem has been a lot of these external factors—the rising administrative cost by increased regulations and other factors—but the system itself is pretty healthy.

Mr. PRICE. Thank you. Thank you, Mr. Chair.

Mr. KLINE. I thank the gentleman. The gentleman's time has expired.

Mr. Payne, would you care to inquire?

Mr. PAYNE. Thank you very much.

I'm sorry I missed all the testimony, but being an old-timer, I'm one that certainly supported defined benefit plans, and with much of what's going on today, really, you know, kind of puts in doubt people's guarantee for a future.

I just have a question here.

The administration, the plan here, the way I look at it, penalizes workers by cutting Federal pension guarantees, penalizes workers by outlawing benefits that protect workers in event of a plant shutdown. It penalizes workers by restricting the benefits workers earn at companies with financial difficulties.

And where workers here, if they had a union that bargained these benefits with the employers, this proposal, of course, would interfere with existing collective bargaining agreements.

And so I wonder how—where does that leave the union? Does it—I mean, it takes away from previously guaranteed provisions?

Does anybody want to take that on?

Mr. STEIN. Yeah. I think the government's proposals are not—don't have protection of existing employee benefit expectations as one of its sort of preeminent guiding lights.

In my written comments, I make numerous suggestions about, you know, how we can move to better rules while preserving employee expectations, or at least where there is some reasonable transition period.

But yes, I think—I think the—I think if the proposals were leavened by a greater consideration for employees and to some extent for employers, they would be better proposals.

Mr. PORTER. I think that the restrictions proposed by the administration is one way.

Since it is not the government that supports pension plans that fail, it is other companies and other organizations that have their own plans to support the plans that fail, there needs to be an adequate balance somehow between what has been appropriately and legitimately bargained between an organization and their employer and the fact that there are many other participants to this equation who were not party to that negotiation.

So what that balance is, I think we can all work together toward appropriate conclusions and how it would be, whether the administration's proposal or others, but there needs to be a balance somehow between those who guarantee ultimately pension plans that fail and those that fail.

Mr. STEIN. One of the proposals specifically about plan shutdown benefits that I make in my written comments, I guess it has two aspects.

One is the current scheme should remain through the end of collective bargaining agreement terms, and the second proposal was that we investigate the establishment of a separate insurance fund for plan shutdown benefits.

If you want to have a plan shutdown benefit, you would pay risk-based premiums to the PBGC for those particular benefits.

Mr. PAYNE. Thank you. Thank you very much.

Mr. KLINE. I thank the gentleman.

Mr. Tiberi, would you care to inquire?

Mr. TIBERI. Thank you, Mr. Chairman.

I think the Chairman, Chairman Boehner put it right when he said it was a balancing act as we move forward.

I want to get your thoughts on this issue.

I have a number of employers in my Central Ohio district that are concerned. They have funded their plans regularly. They're healthy plans. And they're concerned that what we do here might cause them to do something detrimental to their plans and go to a contribution system rather than a defined benefit system.

Can I get your thoughts, the three of you, on what your thoughts are on what we could do here in terms of increasing, or PBGC increasing their premiums to healthy employers, healthy employer plans, and what that would mean, just your thoughts, each one of you?

Mr. PORTER. May I get a clarification? Are you specifically talking about the PBGC premiums or the funding rules?

Mr. TIBERI. The PBGC premiums.

Mr. PORTER. PBGC premiums, by themselves, add up to a lot of money.

Individually, especially the base premium doesn't seem like that much, but to the extent that the administration's proposal causes a significant increase in the amount of unfunded that plans have, or plans that are now fully funded by any other economic measure to become apparently unfunded, those plans would take on substantial increases in premiums.

And I can't speak for individual plan sponsors as to whether those premiums by themselves would break the bank, but it becomes a contributing factor in decisions of plan sponsors.

And the issue also is, to the extent that plan sponsors are the ultimate payor of plans that fail, there is a concern, right or wrong, that the last one out pays the bill, and I think that needs to be addressed.

Mr. TIBERI. Thank you.

Mr. Stein?

Mr. STEIN. It's a complicated question.

Again, I think the base funding, the base premium amount, $30 per premium, which the government is proposing, I don't think is unreasonable.

Having said that, I agree with Mr. Porter that there is a problem with the premiums that will be risk-based, and one of the things that, again, I discuss in my written comments, is the possibility that we might use those premiums as a separate fund within the plan that would be used simply if the plan fails to provide for the guaranteed benefits, not for other benefits, and thereby improve the funding of the plan with the money you're paying out.

I think there is a problem. I think there's an inherent problem in the way PBGC is structured. Your premium pays for two things. It pays for the risk that your plan will terminate.

If you're a healthy plan, you're also subsidizing, as a number of people have said today, the plans that aren't well-funded at the moment, and I don't think that that really is—you know, that the universe of sponsors of healthy defined benefit plans doesn't seem to me to be the right universe to be covering that subsidy.

If we want to make it, and I think we should want to make it, we should make it as a society, rather than simply burden people who responsibly fund their defined benefit plans.

Ms. MULVEY. The PBGC premiums, while the percentage increase looks large, they are very small in terms of increases, and by themselves, if nothing else was added in terms of cost, it wouldn't be a big issue.

But i think those premium increases, along with all the other issues that we've talked about, will hit those industries like manufacturing, which will have a difficult time paying for those increased costs.

Mr. TIBERI. Mr. Porter, you mentioned the issue of investments and conservative investments.

Can all three of you touch upon how over a 10-year period moving toward a more conservative approach to investing will have an impact on PBGC—your thoughts?

Mr. PORTER. We can—I can look at history as an example.

Pension funds for most employers are diversified. Studies indicate that diversity is the best security, and those funds have been earning well in excess of most of the plans' assumptions for long-term assumptions, over many years.

So if you were today to immunize your portfolio so that you invested in a way that exactly matches the liability proposed by the administration—which by the way is not physically possible—you would have conceded that your plan going forward would earn something close to five or five-and-a-half percent, maybe six, over the long term, and yet it's hard to find too many successful pension plan trusts that have made that little in any reasonable length of, period of time.

So that foregone investment, if 9 percent is a reasonable long-term assumption—some people have challenged whether it is, but if you look at history, it's hard to find a period over the last thirty years where that hasn't been true—that's 3 percentage points, that's 3 percentage points that have to be funded by the plan sponsor instead of achieved through investment.

That causes the plan to increase precipitously relative to the cost of a defined contribution plan.

Mr. TIBERI. Thank you.

Mr. KLINE. The gentleman's time has expired.

The gentleman from New Jersey, Mr. Andrews, is recognized for 5 minutes.

Mr. ANDREWS. Thank you, Mr. Chairman.

I thank the witnesses, and I apologize for not being present for your testimony, but I appreciate you preparing it in written form so we can review it.

This will come as a surprise to some people in this room, but there are some people who do not follow the yield curve debate in America, who don't—

[Laughter.]

Mr. ANDREWS [continuing]. And what's also not surprising is that most people would think that this is a very arcane and abstract issue. I do not think that it is.

I think that the kind of interest rate assumptions we write into this law are critical to the question of whether people maintain defined benefit plans or not, because it has been my experience, and as I said to the earlier panel, in listening to employers and union leaders and experts in this field, such as actuaries across the country, that there is a relationship between volatility and maintenance of these plans.

The more volatile your assumptions are, the less likely you are to maintain one of these plans, and as I said earlier, as someone who has a bias in favor of maintaining these plans, I look at the yield curve debate as rather critical to that answering of that question.

I know that each of you has had comments about the yield curve proposal in your written testimony.

We heard from the earlier panel, the administration defended its proposal essentially in two ways.

The first was that, taken as a package, they argue that their reforms in the defined benefit law make defined benefit plans more desirable and will enhance their retention and perhaps even

growth, so they say that you have to look at the other issues, like pre-funding and so forth, to evaluate the question.

The second argument they make is that the curve could be done by an actuary on one spreadsheet, I think the comment was.

I think that all three of you think that they're wrong. I know that Mr. Stein was—his comments really focused on the small business aspect of this, about the burdens.

But if you think they're wrong, why are they wrong? Why should we adopt something other than the administration's yield curve proposal in this instance?

And I would ask each of three of you to answer the question.

Ms. MULVEY. I think the problem is if the yield curve were implemented right away it would hurt those that have older workforces, older than average, and many of these plans are well-funded already that they're aiming to raise the cost to.

So I think that the system was working the way it was in terms of the interest rate, and why fix something if it's not broke?

Mr. ANDREWS. I think you also commented on the long-term. You say the volatility also would make it more challenging for firms to develop reliable long-term financial and/or strategic plans for their companies.

So it's not simply the fact that well-funded plans today would be perhaps forced to make contributions that they ought not make. There's a longer-term consequence too, isn't there?

Ms. MULVEY. Yeah, and that has to do with more the spot rate versus the 4-year average than the yield curve itself.

Mr. ANDREWS. OK. Mr. Stein?

Mr. STEIN. I'm a little bit different. I'm not against use of the yield curve in appropriate situations.

The problem that I have with the yield curve is it's useful for the snapshot we use in today's deficit reduction contribution.

It's useful if we're worried about a plan terminating, and more accurately measuring liabilities, even given the, I think, very insightful critique you made of how it's not really—you know, the yield curve is going to be very sensitive to changes in the workforce, which the administration proposals, I think, assume is more or less static.

But most employers, I think we can look at their plan more as an ongoing enterprise, and we don't have to be worried about minute-to-minute accurate snapshots, and to the extent that we're going to in the name of some kind of, you know, theoretical purity use the yield curve and increase volatility, I think that's a mistake.

Mr. ANDREWS. OK. Mr. Porter?

Mr. PORTER. I have three issues.

One is what happens in periods of high interest rate? I'll explain that in a second.

The second is, it's not really always accurate.

And the third is, we take exception to the administration's view that yield curve is used for virtually all financial transactions, or many of them.

If you look back in the early 1980's and late 1970's, when interest rates were double digit, and there were periods of time when the yield curve was inverted, a legacy pension plan with lots of re-

tirees would have been using a discount rate well in excess of 15 percent in some of those years.

The funded status, to be fully funded would require almost no assets, less than 50 percent—excuse me—about 25 percent of what we would require as full funding today for the same plan.

If you take a plan—I've done an analysis internally, which needs to be done more broadly through, but it just challenges, it's one person's analysis, but if you took a fully funded plan in the mid-1970's and followed these rules, as interest rates spiked during the early 1980's and then started a gradual decline over the next decade or two, the plan would not have been permitted to make contributions in six or seven of those years as interest rates were going up because it would have been considered grossly over-funded.

Mr. ANDREWS. Which is certainly counterproductive to—

Mr. PORTER. Yeah. So contributions that were actually made in that period would not have been made. Plans would have had less assets. Going into the period when pension trusts earned 12, 13, 14 percent compound, those assets would not have been there earning them, so pension plans would be less well-funded today.

Those plans would have then had to make contributions in the 1990's, when the economy was starting to weaken, to make up for the foregone contributions—

Mr. ANDREWS. Your point is borne out by the fact that within the last 25 years, we've seen a prime rate as high as 17, and as low as what, three-and-a-half or something.

Mr. PORTER. That's right.

Mr. ANDREWS. I mean, it could certainly happen again.

Mr. PORTER. My second comment is that we talk about accuracy, but if you look at what the available marketplace is for AA corporate bonds, it's pretty thin, and the Treasury goes through a 90-day period to get enough points, but there's a lot of points where there are no assets.

Our plan has an average duration, an average duration of about 12 years, and there are very few investments out there that could be used to match that cash-flow, so we would have to rely on investments other than that to actually—you know, we can't actually duplicate on a pure basis that particular number.

And the third is, there was a comment made that everybody does yield curves for everything else.

And it's true the yield curve is used for certain financial purchases, but corporations use other things, like return on equity when making decisions.

When we decide to build a plant or add to a production somewhere in the world, we're not looking at the yield curve. We've looking at how will that plant, what will it return in relation to our total cost of debt, which includes cost of equity as well as the cost of borrowing, and it's a much higher rate, what is used for the threshold for determining whether to build a plant or add a production line.

Mr. ANDREWS. I read the Chairman's speech from last September on this subject, and my sense is that the yield curve does not fit his principles that he articulated, either.

I thank you very much for your testimony.

Mr. PORTER. Thank you.

Chairman BOEHNER. I appreciate my colleague pointing that out.

[Laughter.]

Chairman BOEHNER. The Chair recognizes the gentleman from Minnesota, Mr. Kline.

Mr. KLINE. I thank you, Mr. Chairman.

I just want to say that I'm shocked—shocked—to learn from my colleague, Mr. Andrews, that not all of America is following the yield curve debate.

[Laughter.]

Mr. KLINE. I find that remarkable, and I will talk to him after the hearing to find out if that pandering to the Chairman works out for him.

[Laughter.]

Mr. KLINE. I'm certainly willing to try that.

Mr. ANDREWS. It really doesn't.

[Laughter.]

Mr. KLINE. I suspected that might be the case.

I was very much—we had wonderful hearings, and as the witnesses know and all my colleagues know, that discussion, the debate has been going on for some time about how do we in fact resolve the retirement security crisis and make sure that in whatever we do, that the retirees, the PBGC, the taxpayers, the employers are all respected in this.

And I've told the Chairman and my colleagues that if we end up at the end of the day with a policy that doesn't do that, that for example, puts companies into bankruptcy, then we have failed in our effort to create some good policy.

And I was intrigued with Professor Stein's approach of recognizing that we have some, if I could call them legacy problems that we may need to look at one way, and in the future in another way.

I have a couple of technical questions that I've been talking to staff about. They happen to be for Mr. Porter. I'd like to ask those, and then I'll be able to yield back.

Mr. Porter, if credit balances are completely eliminated, will companies still have the incentive to make additional contributions to their plans?

Mr. PORTER. That's a two-edged sword.

Mr. KLINE. As are they all, sir.

Mr. PORTER. The administration's proposal, when interest rates are low, permits companies to make very large contributions that will be totally unnecessary if interest rates go up.

If interest rates are high, it cuts back the ability to make contributions that might well be needed later.

So there is flexibility, provided the plan is fully funded by the administration's yield curve proposal.

If a plan is less than fully funded and is facing annual contribution requirements under the proposal, the only flexibility the plan sponsor has is to contribute a one-time contribution to bring it to full funding or above. Otherwise, they have no flexibility.

Let me give you a quick example.

If you had to make a $100 contribution every year for the next 5 years, and you would be fully funded at the end of the 5 years, current law would let you say, I'm going to put 300 this year, skip

a couple years, put a couple hundred in. At the end of 5 years, you're fully funded, just like you would be if you met the minimum funding requirement.

This proposal says I put $100 in, and supposed to put it in, well, I'm going to put 200 this year, I still have to make my 100 next year, still have to make it the next year, I don't get credit for that extra $100 until the fifth year.

So a company that is looking at variability of cash-flow and has a minimum annual contribution will not be able to have any flexibility about when it makes those contributions and will therefore probably choose not to make an extra contribution if I'm going to have to make the same contribution next year.

Mr. KLINE. Thank you. And let me just continue with you on that on another somewhat technical question having to do with tax policy.

I think in your testimony you suggested repealing the excise tax on non-deductible contributions; is that—

Mr. PORTER. That's correct.

Mr. KLINE. Have I got that right? And why do you think we should do that? Why is that tax unnecessary?

Mr. PORTER. It all depends on what else you do.

[Laughter.]

Mr. PORTER. Let me just paint a scenario for you.

We've heard some talk about legacy plans, and certainly the DuPont pension plan, we have a lot of retirees in our plan, so it would qualify by some definitions as a legacy plan, very well-funded.

We have several provisions in the tax law that are a problem. One is this 25 percent cap on contributions. One is the excise tax on extra contributions.

As the interest rates were declining over the 1990's, we were not permitted to make a contribution. My management actually came to me and said, "Ken, is it now time to make a contribution?" And I said, "You can't because you'd be charged an excise tax."

So if there's nothing else done, the excise tax did keep us from making a contribution.

The 25 percent cap, well, we blow through that right away. We make a normal contribution of normal cost using the discount rates the administration has proposed, because we have 80 percent plus of our liability is with respect to people already retired, 25 percent of payroll is small compared to our pension liability. Twenty-five percent of payroll gives us nothing.

If we were to contribute anything other than the absolute minimum, we would probably lose our defined benefit our defined contribution deduction as it is.

So those provisions, taken as a whole, are very restrictive in the ability of a company with a large pension plan to make any contribution other than the absolute minimum.

Mr. KLINE. Thank you.

Mr. Chairman, my time has expired.

Chairman BOEHNER. Let me thank the witnesses for your excellent testimony.

We've had a number of hearings over the last several years. Matter of fact, I could probably talk about the last 6 years that we have had hearings looking at the condition of our pension system,

and I'm looking forward to, in the coming weeks and/or months, introducing our pension proposal, and looking for swift action this year on an overhaul of our defined pension benefit rules.

So I want to thank all of you for your help and look forward to seeing all of you again.

This hearing is adjourned.

[Whereupon, at 12:38 p.m., the Committee was adjourned.]

[Additional material submitted for the record follows:]

**Statement of Hon. Charlie Norwood, a Representative in Congress from the State of Georgia**

Mr. Chairman, I thank you for holding today's hearing to thoroughly examine the Administration's policy proposal to reform the voluntary single-employer private pension system. This Committee has held countless hearings over the past two years to analyze this issue, and your leadership in providing direction to the Administration regarding the American retirement security crisis is laudable.

It is a well-known fact that American workers are staring down a number of crises regarding their retirement security. The Pension Benefit Guarantee Corporation is facing a record $23 billion debt, fewer employers are offering defined benefit pension plans, and some have even frozen or terminated their pension plans altogether.

In such a climate of uncertainty, Mr. Chairman, it is no wonder that employees continue to fret for their financial future. After all, folks who've worked for a company their entire lives depending on the promise of a generous private pension can no longer simply trust that their needs will be met. Thousands of United Airlines employees who lost their pensions last year can tell you that.

Mr. Chairman, this Committee has a responsibility to ensure that what happened to hard working employees of United Airlines does not happen again. We must therefore provide employers with the tools they need to continue financing and funding these defined benefit pension plans, and this hearing designed to vet the Administration's reform proposal is a good place to start.

It is imperative that Congress and the Administration work together to provide employees reaching their golden years with peace of mind regarding their retirement security. But it is just as important, Mr. Chairman, to ensure that our younger employees who will spend the next 10, 20 or 30 years in the workforce can benefit from a strong, flexible defined benefit pension system on solid financial ground.

I look forward to the testimony from our distinguished panel of witnesses, and hope that we can all gain a better understanding of how Congress and the Administration can move forward to ensure that our workers retire with dignity and security.

Thank you Mr. Chairman, and I yield back.

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**Statement of Hon. Jon C. Porter, a Representative in Congress from the State of Nevada**

Good morning, Mr. Chairman. Thank you for convening the Committee on Education and the Workforce for this most important hearing. I also wish to extend my appreciation to this panel of witnesses for sharing their experience and knowledge on the impacts of reform on our current pension system. Ensuring that Americans are financially secure in their retirement should remain one of the highest priorities of this committee and this Congress.

As an increasing number of Americans prepare for a retirement that will last significantly longer than past generations, our job of examining the pension security of all Americans becomes increasingly important. While seeking to create secure retirements for all Americans, we must ensure that the structure of our pension system will not negatively impact the American taxpayer. Providing the Pension Benefit Guarantee Corporation with the financial footing that will allow continued assurances of the strength of pension programs requires an intense study of the vulnerabilities of our current system, and the issues that pension plans have faced in recent years.

I would also like to mention, Mr. Chairman, that as we move forward with the reforms proposed by Chairman Boehner and by the Bush Administration, we must seek out ways of encouraging American workers to gain a more comprehensive understanding of their retirement futures. The need for adequate education on and understanding of the financial needs of retirees has become paramount. As we look at means of augmenting the dissemination of this kind of knowledge, we must ac-

knowledge that significant numbers of Americans lack the essential knowledge to ensure that their retirements are not fraught with the distresses of poverty.

Again, thank you Mr. Chairman for convening this necessary hearing. I am sure that the insight of these witnesses will better equip all of us who sit on the committee to better comprehend the situation that this Congress faces in bringing needed reforms to our pension system.

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**Statement of the Society for Human Resource Management, Submitted for the Record**

Chairman Boehner and Ranking Member Miller:

The Society for Human Resource Management (SHRM) applauds your collective efforts over the past several years to craft legislation that will ensure the integrity of the defined benefit (DB) pension system and the solvency of the Pension Benefit Guarantee Corporation (PBGC). SHRM and its members remain committed to a flexible pension system that meets the retirement needs of its workforce and the financial goals of its organizations. Specifically, SHRM wants to make sure that pension promises are kept and pension plan requirements are equitable yet effective.

The Society for Human Resource Management (SHRM) is the world's largest association devoted to human resource management. Representing more than 190,000 individual members, the Society's mission is to serve the needs of HR professionals by providing the most essential and comprehensive resources available. As an influential voice, the Society's mission is also to advance the human resource profession to ensure that HR is recognized as an essential partner in developing and executing organizational strategy. Founded in 1948, SHRM currently has more than 500 affiliated chapters and members in more than 100 countries.

As public and private employee benefit plan sponsors, managers and administrators, HR professionals are intimately involved in all aspects of pension plan management and administration. We appreciate this opportunity to share with you our thoughts on the Administration's proposal to strengthen funding for single-employer pension plans and offer the following specific comments on the Administration's proposal:

*Improve Disclosure*

The Administration proposes to provide increased information about a plan's funding status and timelier plan funding information. SHRM supports increased disclosure to plan participants on plan funding and financial status but remains concerned that some information or actuarial calculations may be overly complex for both plan sponsors and plan participants. SHRM is worried that complex actuarial assessments or assumptions, without comprehensive and lengthy explanations, may lead to confusion. Such false impressions or misunderstandings about plan solvency could generate unwanted economic market fluctuations, inconsistent industry information, and undermine confidence in the plan's solvency.

*Determining Liabilities*

The Administration proposes to base the interest rates used for present value calculations for pension funding obligations on a yield curve valuation. SHRM supports using a more accurate valuation method as it provides a better indication of a plan's obligations. However, we are hesitant to fully support the yield curve valuation method because it potentially introduces increased volatility in assessing plan liabilities. Plan liabilities would become dependent not only on fluctuations in interest rates but also on changes in the shape of the yield curve and on changes in the duration of plan liabilities. This type of volatility in pension obligations undermines employers' ability to predict and budget their costs and has already been a significant deterrent to organization's retaining DB plans as a retirement plan option. SHRM believes there are alternate valuation models that approximate the effect of a yield curve without adding as much complexity to the calculations or actuarial volatility; which if continued would maintain the current trend of employer's preferences for other types of qualified pension plans.

*Minimum Funding Credit Balances*

The Administration proposes that the minimum required contribution to the plan for the year would be equal to the sum of the applicable normal cost for the year and eliminates the alternative minimum funding standards. SHRM supports employer flexibility to assist in the management and administration of pension plans and would therefore encourage policies that would permit credit balances. Furthermore, the elimination of the alternative funding standards limits funding flexibility as well as the need for a funding standard account. Although making larger than

required contributions would not directly reduce a sponsor's future minimum funding requirements, SHRM believes the additional contributions could accelerate the date when the plan's assets reach its funding target (eliminating the need for amortization payments), reduce the amount of otherwise required new amortization payments, remove certain restrictions on plan benefits, and reduce PBGC premiums.

*Tax Deductible Contribution Limits*

The Administration proposes to permit funding on a tax deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year.

SHRM supports the Administration's proposal to increase the spread between the minimum funding target and the maximum tax-deductible level. This approach provides a way for organizations to stabilize contributions from year to year. SHRM also suggests that considerations be made to allow limited access for post-retirement medical benefits under IRC Section 420. SHRM believes this option would increase an employer's flexibility in providing post-retirement benefits.

*Phased Retirement*

Although not addressed in the Administration's proposal, SHRM believes Congress should create a formal phased retirement structure in order to assist employers in workforce replacement challenges anticipated as a result of the impending retirement of the baby boom generation. A nontraditional work schedule with retirement flexibility—phased retirement—will be a key workplace issue in the 21st century.

*Contributions During Economic Prosperity*

The Administration's proposal strives to provide employers with additional flexibility while meeting the plans financial obligations. SHRM believes organizations should be permitted to make additional contributions during times of economic prosperity. Providing this option for employers sets an example for "planned responsible saving" and provides organizations with additional flexibility during times of unforeseen economic downturn.

SHRM supports Administration and Congressional efforts to encourage continued and new participation in the defined benefit system as well as measures to ensure that plans fully meet their funding obligations. SHRM especially appreciates the Administration's proposal to simplify the current funding rules by essentially establishing one set of required calculations.

SHRM believes that government shares responsibility with Americans to achieve adequate retirement income, and encourages Congress to continue supporting a voluntary employer-provided retirement system for employees. We look forward to working with you in the months ahead to develop a long-term solution that will ensure the integrity of the DB pension system and the solvency of the PBGC. Thank you.

Respectfully,

Susan R. Meisinger, SPHR
President and Chief Executive Officer

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**Statement of the ERISA Industry Committee, Submitted for the Record**

Mr. Chairman and Members of the Committee, thank you for the opportunity to present the views of The ERISA Industry Committee (ERIC) on the Bush Administration's proposals to reform voluntary single-employer defined benefit pension plans.

> ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

In recent years, the House Education and Workforce Committee has increasingly taken an active role in conceiving and moving to enactment legislation that improved voluntary retirement savings. For example, provisions of the Small Business Job Protection Act of 1996 (P.L. 104–188), the Taxpayer Relief Act of 1997 (P.L. 105–34), the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107–16), and the Pension Funding Equity Act of 2004 (P.L. 108–218) supported retire-

ment savings both by increasing opportunities for savings and by providing more rational rules for employers who voluntarily provide retirement plans to their employees.

*Making EGTRRA Reforms Permanent*

The Committee's recent leadership stands in contrast to legislation enacted during the 1980s when a host of limits, restrictions, and complicated rules were imposed on retirement savings plans as well as other employee benefit plans (see attached chart).

As a result of some of the changes enacted during that decade, funding for defined benefit pension plans was substantially delayed because employers' ability to project and begin to pay for future benefits was constricted through a series of new and reduced limits. Title VI of EGTRRA included provisions that partially reversed some of these funding constrictions, but the improvements will expire in 2010 unless extended by Congress. An extension of these modest improvements in pension funding was included in the President's budget. We urge that when this Committee work toward ensuring that the provisions improving pension funding be made permanent.

*The Impact of Reform*

The Administration has put forward a proposal to re-invent the rules governing voluntary defined benefit pensions. This sweeping proposal has some elements with which we agree but also contains many elements that will reduce retirement security by making it far more difficult for employers voluntarily to sponsor defined benefit pension plans.

The future of voluntary employer-sponsored defined benefit plans now is in Congress's, and this Committee's, hands. Whether at the end of the day employers are provided with a voluntary system that encourages them to establish, maintain, and fund pension plans—or whether they are faced with a system that discourages and even penalizes such actions will depend on the ability of Congress and stakeholders to find the right balance of rules and opportunities, risks and protections.

No system can be totally risk free and full proof. Any workable, sustainable system needs to balance legitimate concerns for security with equally legitimate concerns for business and economic competitiveness and flexibility.

This is an important conversation, and ERIC welcomes the opportunity to work with the Committee and the Administration to build a more robust voluntary defined benefit pension system.

*A Sound PBGC*

ERIC supports a soundly financed Pension Benefit Guaranty Corporation. As the PBGC has stated, the agency faces long term issues but does not face a liquidity crisis. It has on hand sufficient assets to pay trusteed benefits for many years into the future. Moreover, when it trustees a plan, its asset base grows. Potential issues regarding the PBGC are long term issues.

In that regard, we note that of the $23 billion deficit published by the agency at the end of 2004, $17 billion (or nearly three-quarters) was due to claims that had not yet been received by the agency—called "probable" claims. Probable claims are those the agency expects to receive in the near future, although not necessarily in 2005. Thus, airline plans recently trusteed by the PBGC most likely are already included in this deficit calculation and do not increase any reported deficit. (See chart)

*The Administration Proposal*

The Administration proposes to replace the current-law long-term and short-term funding rules with funding rules based on spot measures of funded status as well as on the assumed financial health of the sponsoring employer; to modify disclosures made to the general public and to participants; to substantially increase premiums paid to the Pension Benefit Guaranty Corporation as well as the number of employers who pay a variable premium; and to restrict benefits available to participants in certain circumstances.

*Permanent Interest Rate*

ERIC strongly supports the Administration's proposal to provide a permanent interest rate that is based on corporate bonds, even though it disagrees with the specific construction of that rate chosen by the Administration (i.e., a yield curve). Uncertainty over the applicable interest rate has caused many plans to be frozen over the past few years and impeded sound business planning. Providing stability in this key assumption is critical. Long-term corporate bond rates enacted by Congress for 2004 and 2005 provide a realistic picture of plan liabilities and reflect a very conservative estimate of the rate of return earned by pension trusts. The 2004–2005 solution should be enacted on a permanent basis.

*Deductible Contributions*

ERIC also strongly supports the proposals such as those put forward by the Administration that will increase limits on deductible contributions so that employers can fund up in good times and build cushions that will help them weather downturns. There are several proposals put forward by the Administration, Members of Congress, and stakeholders that deserve consideration. The specific provisions that will be most effective, of course, will depend on the final structure of the underlying funding rules chosen by Congress.

*Disclosure*

As stated in its principles, ERIC also agrees that more meaningful and current disclosure can be provided to participants, although we believe substantial modifications to the Administration's suggestions are needed.

*Key Concerns*

*Volatility and Lack of Predictability*

The current law long-term funding rules, which are based on long-term assumptions, allow companies to know well in advance what their funding requirements will be, and those requirements remain relatively stable over time. The current law deficit reduction contribution (short-term) rules, which are based on a rate averaged over four years, also allow companies to know at least a few years in advance when they may become subject to faster funding requirements.

Because it is based on spot measures of a plan's funded status, the funding construction proposed by the Administration eliminates a company's ability to predict its future contribution requirements. Under the Administration's proposal, a large plan's funded status also can swing back and forth between over funded and underfunded from year to year based solely on external macro-economic factors such as interest rates and short term market performance. The down swings can place cash calls on a company in the billions of dollars.

Pension plans are provided on a voluntary basis, and few companies will be able to tolerate that much risk exposure, especially in something that is not integral to their business product. To abate (but not eliminate) this risk, a company would have to radically overfund its plan and/or modify its investment allocations—and both of these make the plan far more expensive. At a minimum, benefits earned by participants will be reduced to keep overall costs level; in many instances, employers will be pushed out of the system.

We believe instead that the current-law long term rules should be made more effective and that the DRC rules should be made both more effective and less volatile.

*Procyclical Impact*

The current law DRC rules are designed to delay faster contribution requirements triggered by a normal recession until the economy has begun to recover. By contrast, the Administration's spot-rate scheme would exacerbate any downturn by imposing sharp cash calls well before recovery is under way.

The proposal ignores the fact that some plans will become somewhat underfunded during an economic downturn—and that this is normal and poses no risk to the PBGC. By designing rules that essentially require plans to be 100% funded at all times, the Administration has set a bar that is neither rational nor needed in the real world.

In addition, the Administration imposes an expansive definition of liability on any company that drops below investment grade. At a minimum, this part of the proposal is a strong incentive for employers not to sponsor defined benefit plans in the future. Besides the fact that many questions have been raised about how the rating companies operate, the proposed rules may in fact trigger the problems they are trying to resolve. They may trigger a plan termination—and, in the worst circumstances, cause the demise of the company itself. Structuring pension liabilities according to a company's credit rating will cause some companies to be downgraded, increasing their cost of doing business. For a company that is climbing to investment grade, the climb is likely to be much more difficult.

Many, many companies have been or will be below investment grade from time to time and will never terminate a plan that is trusteed by the PBGC. The proposal to base liability calculations on a sponsor's credit rating is like an ineffective and harmful medical test that has too many "false positives."

*Complexity and Lack of Accountability*

The Administration proposes to require use of a corporate bond yield curve that would be constructed monthly by Treasury staff. This is an extraordinary transfer of authority from Congress to agency staff.

Moreover, available markets in the sections of the yield curve that are most critical to most pension plans are thin—thus the staff must interpolate interest rates at those points. This will be very difficult for Congress to monitor, but it can have enormous impact on pension plan funding requirements.

Even though the Treasury will produce a single-page spread sheet of its yield curve, application of the curve is, in fact, complex. Estimates must be made decades into the future regarding the ages at which individuals will retire and the type of benefit distribution they will choose. Application of a yield curve to lump sum distributions also is complex and will be confusing to participants. The current law interest rate also is used in numerous other provisions of pension law—and a yield curve may not be suitable for all of these.

Use of a yield curve will unnecessarily increase the volatility of pension funding since both the interest rates in the curve and the curve itself will fluctuate.

In addition, while the Administration proposes interest rates theoretically tailored to each plan's expected payout, it would still require all plans to use the same mortality tables, creating for some plans a substantial imbalance.

*Disincentives to Pre-fund*

An employer who makes extra contributions will be in a worse economic position than an employer who does not if contributions above minimum requirements cannot count as pre-funding of future contributions. The Administration's proposal to eliminate credit balances should not be enacted. Available credit balances should, however, be adjusted if the underlying value of the assets decreases. This preserves a key incentive for employers to pre-fund their pension obligations during good times while eliminating a flaw in the current law that could allow a plan to use a credit balance even though poor investment results had erased its value.

*Excessive Premium Taxes*

The proposal has been scored as requiring plan sponsors to pay a startling $26 billion in additional premium taxes over the next ten years. Moreover, the proposal would index the flat-rate premium tax to wage growth (regardless of whether the agency needed the funds) and would allow the PBGC itself to set variable rate premium tax levels.

A premium tax increase of this size is not warranted. Moreover, both the indexing and the transfer of authority to the PBGC are inappropriate. Section 4002 of ERISA, states that the PBGC is to "maintain premiums. . .at the lowest level consistent with carrying out its obligations. . ." Automatic indexing, which would occur whether or not the PBGC needed the money, is inconsistent with this directive. It is wholly inappropriate for the PBGC to set the variable premium tax levels. Premium tax levels must balance the financial needs of the agency with the social goals of supporting a voluntary private pension system. Only Congress has the breadth of view and the recognized authority to make these judgments.

*Principles Regarding Pension Funding and Financial Disclosure to Participants*

At a time when members of the Baby Boom cohort are entering their retirement years, the government should assist employers who voluntarily sponsor retirement plans for their employees. Meeting the nation's retirement income needs is an important public policy objective that cannot be met by reliance on government, employers, or individuals alone. Employers offer several different forms of retirement savings vehicles, among them traditional and hybrid defined benefit pension plans in which employees accrue benefits without incurring the risk of investment loss. These plans remain vital to the ability of individuals to achieve financial security in retirement.

ERIC believes the Committee's actions should be based on the following principles governing pension funding and financial disclosure to participants:

Regulatory Environment: The federal government must create a regulatory environment that encourages the establishment, continuation, and long-term viability of defined benefit pension plans by providing plan sponsors with the certainty they need regarding—

* the interest rate used to calculate their liabilities;
* rules that support predictable and stable plan funding
* the validity of cash balance and other hybrid plan designs;

In addition, rules governing pension plans must balance the interests of participants and of employers who voluntarily sponsor defined benefit plans. They must recognize the differences and need for flexibility among employers in plan design and the varying needs and interests of different workforces. Specifically:

* Legislation must be enacted as soon as possible that establishes a realistic and permanent interest rate assumption that appropriately measures the present value of pension plan liabilities and that, with an appropriate phase in, is ap-

plied to the minimum amount of any lump-sum distribution that a pension plan makes. The failure to change the current rate applicable to lump sums has resulted in lump sum distributions that are outsized relative to economic reality and the plan's funded status and has created an artificial incentive for participants to take their benefit in a lump sum.

* Pension funding standards must strike the appropriate balance that encourages employers both to establish and maintain defined benefit pension plans and to fund the plans on a reasonable and appropriate basis, thus protecting participants. This is essential to protecting the financial health of the pension system and the business vitality of plan sponsors. For example, legislation imposing additional requirements or benefit restrictions on plans less than fully funded should not be triggered by the credit rating of the sponsoring employer. This measure creates too many "false positives." It would impose unnecessary burdens on a large number of employers who otherwise are not likely to terminate their plans, making their business recovery more difficult and in some cases triggering the very plan termination that the funding rules should seek to avoid.
* Employers must not be discouraged from developing new plan designs that meet the changing needs of the current and future workforce. Legislation must be enacted that confirms the legality and facilitates the adoption and continuation of hybrid plans so that employers will be more likely to continue to offer pension plans.
* The Pension Benefit Guaranty Corporation (PBGC) must align its objectives with those of employers and participants since a flourishing private pension system is the best guarantee of the PBGC's long-term viability. In other words, as required under ERISA, PBGC must set policies and act to encourage the establishment and continuation of voluntary defined benefit plans. Plan funding and premium policies should not force employers out of the voluntary pension system prematurely and unnecessarily during periods of financial distress or normal economic downturns.

Funding Objectives: In order to ensure that employees will receive pension benefits from employer-sponsored plans, the primary objectives of funding standards must be to foster plan continuation through actuarially sound funding and to allow plan sponsors to anticipate systematic and stable funding over time.

* Required contributions must be both predictable and stable in order to facilitate capital planning in the sponsoring business.
* Funding standards should permit the pre-payment of contributions when sponsors are able to do so.
* Funding standards must allow and facilitate diversification of investments of pension plan assets, including investments in equities, in order to ensure the growth and security of the plan.
* Funding standards must recognize the on-going and long-term nature of pension plans; the primary focus of funding requirements should be based on long-term measures and long-term assumptions.
* Short-term measures of a plan's funded status should be monitored and taken into account in funding and disclosure decisions, but also must balance funding goals with the need to avoid forcing plan sponsors to choose between funding their plans and maintaining the viability of their businesses.

Financial Disclosure to Participants: More meaningful and more current disclosure is needed. Summary annual reports are not meaningful. Investors receive better and more current information than do plan participants.

* Plans should be required to provide participants early each year with a statement of the plan's funded status based on timely information currently available—such as information on plans compiled for SFAS 87 disclosures.
* The new report should replace the summary annual report.
* As under current law, plans may provide participants with additional information.

Underfunded Plans: To prevent the occurrence of benefit accruals that are not likely to be funded within a reasonable period of time and to reduce the PBGC's exposure to such benefit accruals, special restrictions on benefit increases and payouts should be imposed on plans that are severely underfunded and likely to terminate. This will limit cost shifting from failed plans to ongoing plans through increased PBGC premiums.

* Restrictions should be imposed on a graded scale—the most severe restrictions reserved for the most underfunded plans.
* Restrictions imposed on benefit accruals or lump sum distributions must be workable and as minimally disruptive of business operations, workforce man-

agement goals, and participants' needs as possible, and not invite or lead to lawsuits against employers.

*Conclusion*

To secure defined benefit pension plans and lay the groundwork for their expansion in the future, Congress must take action now to:

* adopt the long-term corporate bond rate as a permanent interest rate for calculating liabilities, and
* provide legal certainty for hybrid plans.

However, before enacting pension funding reforms, Congress must ensure that reforms result in rules that support predictable and stable plan funding.

The Administration has stated that it wants to ensure that plans are funded so employees will be assured of receiving their benefits. We agree. But aspects of the specific proposal put forward are so harsh, volatile and unpredictable that many plan sponsors will be forced to freeze their plans, and in some cases may be forced into bankruptcy. Moreover additional workers will not have the opportunity to earn pension benefits because their employer will not consider installing a defined benefit plan under such a structure.

The Administration also has stated it wants to avoid a taxpayer bailout of the PBGC. We agree. But the best assurance of a sound PBGC is a robust defined benefit system. We do not believe that the Administration's proposal accomplishes this goal and in fact may put the PBGC in a worsening position.

We appreciate the opportunity to present our views and look forward to working with the Committee and the Administration to provide opportunities for American workers to attain lasting retirement security.

[An attachment to the ERISA Industry Committee's statement follows:]

## BUDGET REDUCTIONS* AFFECTING EMPLOYEE BENEFITS

## LAWS ENACTED 1982 - 1994

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TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 **(TEFRA) P.L. 97-248**
Lower limits to compute pension contributions and benefits (I.R.C.§415) from $136,425 and $45,475 to $90,000 and $30,000, frozen until 1986; reduce combined plan limit. Limit plan loans. Require plan distributions at age 70-1/2 or retirement. Reduce integration in defined contribution plans. Impose stricter leased employee rules. Impose new nondiscrimination rules on group term life insurance (I.R.C.§79).

**Est. five year net revenue gain of $3.872 billion (1983-1987)**
[Est. three year gain: $1.844 billion]

DEFICIT REDUCTION ACT OF 1984 **(DEFRA) P.L. 98-369**
Freeze §415 limits until 1988. Repeal PAYSOPs. Limit deductions for contributions to I.R.C.§501(c)(9) trusts (VEBAs). Impose limits on group term life insurance for retirees. Repeal estate tax exclusion for qualified plan benefits. Expand leased employee restrictions. Expand nondiscrimination standards for 401(k) plans. Restrict tax exclusion of fringe benefits and benefits available under cafeteria plans (I.R.C.§125 plans). Limit vacation pay; and make other changes.

**Est. five year net revenue gain of $4.094 billion (1985-1989)**
[Est. three year gain: $2.472 billion]

CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985 **(COBRA) P.L. 99-272**
Require continuation health coverage ("COBRA coverage"). Increase PBGC premiums; restrict plan terminations.

**Est. three year net revenue gain: $0.666 billion (1986-1988)**

TAX REFORM ACT OF 1986 **(TRA-86) P.L. 99-514**
Limit deductions for business meals, travel, and entertainment. Restrict availability of IRAs. Impose cap on elective contributions to and impose new nondiscrimination rules on 401(k) plans. Impose tax on pre-retirement distributions. Repeal 10-year averaging. Repeal three year basis recovery. Reduce early retirement §415 limits. Reduce deduction limits for plan contributions. Impose 10% excise tax on reversions. Cap dependent care assistance. Impose nondiscrimination rules on welfare benefit plans. Limit ESOPs; and make other changes.

**Est. five year net revenue gain of $50.299 billion (1987-1991)**
[Est three year gain: $28.794 billion]

OMNIBUS BUDGET RECONCILIATION ACT OF 1987 **(OMBRA) P.L. 100-203**
Reform pension funding. Impose 150% of current liability cap on pension funding. Increase PBGC premiums; and make other changes.

**Est. three year net revenue gain 1988-1990: $3.580 billion**

TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988 **P.L. 100-647**
Increase excise tax on reversions. Make numerous technical corrections. Change COBRA penalties. Modify Section 89; and make other changes.

**Est. three year net revenue loss 1989-1991: $0.279 billion**

OMNIBUS BUDGET RECONCILIATION ACT OF 1989 **P.L. 101-239**
Restrict ESOPs. Restrict prefunding of retiree health. Impose new mandatory penalty on violations of ERISA. Extend educational assistance and legal services. Expand COBRA; and make other changes.

**Est. five year net revenue gain: $9.390 billion (1990-1994)**

OMNIBUS BUDGET RECONCILIATION ACT OF 1990 **P.L. 101-508**
Allow transfers of excess pension assets to pay for retiree health benefits. Increase excise tax on pension plan reversions. Increase PBGC premiums. Extend user fees. Extend educational assistance and legal services; and make other changes.

**Est. five year net revenue gain: $354 million (1991-1995)**

BUDGET RECONCILIATION ACT OF 1993 **P.L. 103-66**
Repeal the Medicare hospital insurance (HI) taxable wage base cap. Reduce the amount of compensation that can be taken into account in computing pension contributions and benefits from $235,840 to $150,000. Extend educational assistance. Facilitate real estate investments by pension funds.

**Est. five year net revenue gain: $30.398 billion (1994-98)**
[Repeal of HI cap = $29.1 billion five-year revenue gain]

GATT IMPLEMENTATION ACT 1994 P.L. 103-465

GATT IMPLEMENTATION ACT,1 994 P.L.103-465
Reform pension funding and provisions of law affecting the PBGC (including removing cap on variable rate premium). Extend retiree health transfers under IRC §420. Slow down indexing of plan limits.

**Est. five year net revenue gain: $1.757 billion (1995-99)**

IN ADDITION: For the past several years, each budget reduction has included billions of dollars in "savings" in federal payments under Medicare and Medicaid. This has resulted in increased charges to other payers (including employee benefit plans). The Prospective Payment Commission has estimated that costs to other payers have increased an average of 28%.

* NOTE: The revenue estimates included in this memorandum are the estimates provided at the time of the bill's passage by Congress. They do not reflect subsequent changes in underlying tax rates or in other provisions of law. Several bills include benefit provisions that increase federal expenditures as well as provisions that reduce federal expenditures. The estimates included in this memorandum are net amounts.

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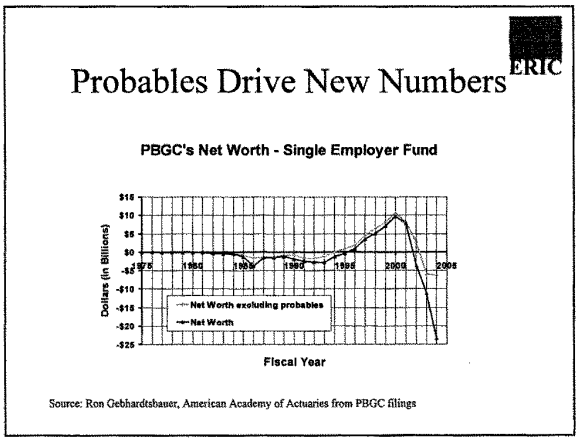


## Statement of the American Society of Pension Professionals & Actuaries, Submitted for the Record

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the House Committee on Education and the Workforce on several important elements of defined benefit reform. ASPPA is a national organization of almost 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

ASPPA applauds the Committee's leadership in exploring defined benefit funding reform. The Committee on Education and the Workforce's consistent focus on pension issues over the years has advanced improvements in the employer-sponsored pension system, as well as led to an increased awareness of the need to focus attention on the retirement security of our nation's workers. ASPPA looks forward to working with Congress and the Administration on strengthening the defined benefit system.

*Maximum Deductible Contribution Limit*

The Administration has stated that their defined benefit reform proposal is intended to strengthen workers' retirement security by ensuring that defined benefit plans are adequately funded. To this end, they have proposed a maximum deduction amount using a combination of a plan's new ongoing liability funding target and a 30 percent cushion of such new funding target. ASPPA believes that this new maximum deduction limit does not adequately address the needs of small to medium-sized companies.

For a healthy plan sponsor, the Administration's new maximum deductible contribution would be equal to the present value of all accrued benefits, (assuming a salary increase factor and computed using the proposed yield curve), plus a 30 percent cushion of this amount. The Administration has stated that their suggested reforms to the current defined benefit funding rules, including the maximum deduction rules, ensure adequate funding and would provide greater flexibility for employers to make additional contributions in good economic times.

After close analysis of the Administration's proposed maximum deductible contribution limit, in conjunction with the allowable actuarial assumptions for such a calculation, ASPPA has discovered that in certain circumstances involving small to medium-sized companies, the Administration's proposed maximum deductible contribution limit would actually be decreased, rather than increased, as compared to current law. This would preclude small to medium- sized employers from funding their plans sufficiently as they can under current law. Thus, rather than strengthening the funding rules, the proposed reform would, in some cases, actually weaken them.

Consider the following example: A defined benefit plan has been established with 21 participants (6 highly-compensated and 15 non-highly compensated), with a defined benefit formula based on 4 percent of average pay for each year of participation up to a maximum of 25 years. Under current law, and based on allowable actuarial assumptions, the maximum deductible contribution that could be made to this defined benefit plan would be $382,914. The maximum deductible contribution allowable under the Administration's formula, based on a yield curve and allowable actuarial assumptions, would be $273,048. This amounts to a funding difference of $109,866, which is certainly significant for a small business. Although this funding difference occurs when a plan is first established, it is important to keep in mind that this funding deficiency will have to be made up later, when the small business may not be in a financially-sound position to do so.

The reason for this discrepancy in the maximum deductible contribution is based on the fact that the Administration's proposal, although allowing for an assumption for salary increases for workers, does not allow the plan to assume salary increases for many small business owners. This is because the Administration's proposal does not permit the plan to assume the statutorily provided inflation increases in the compensation limit for determining benefits [IRC section 401(a)(17)].[1] As a consequence, some plans will not be able to fund for these small business owner benefits, even though the law allows such benefits to be accrued. The resulting funding mismatch is a particular problem for successful small businesses. While some plans would be able to take advantage of the 30 percent cushion provided under the Administration's proposal, many others, such as the small business in this example, would not.

For many small and medium-sized companies, not being allowed to assume the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit will create an inappropriate funding deficiency when a plan is first established. Thus, since the Administration's current proposal effectively discriminates against the benefits of many small business owners, the plan will potentially have a funding shortfall just as it starts. Significantly, under the above example, if the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit were allowed to be assumed, the maximum deductible contribution limit under the Administration's proposal would increase to $363,313, a contribution limit similar to current law.

Based upon these results, ASPPA recommends that the Administration funding proposal be modified to permit the statutorily provided inflation increases in the IRC section 401(a)(17) compensation limit to be assumed for purposes of calculating the maximum deductible contribution limit in order to assure funding adequacy for all plans, including small businesses. As we have shown, the Administration's proposal would unfairly discriminate against successful small businesses and hinder

[1] The annual compensation limit under the "401(a)(17)" limit cannot generally exceed $200,000, to be adjusted for cost-of-living increases beginning in 2002. The current 401(a)(17) limit for 2005 is $210,000.

the creation of new defined benefit plans. Concurrently, ASPPA supports an increase in the deduction limit of a plan's ongoing liability funding target from the proposed 130 percent to 150 percent of such target. By increasing this cushion, employers would be provided with more flexibility in determining their pension contributions, particularly in good economic times. Being able to make additional pension contributions in good times would also be consistent with the Administration's proposal that defined benefit plans be adequately funded.

*Disclosure under Schedule B of the Form 5500*

A main concern of the Administration is that the asset and liability information provided under the current Schedule B of the Form 5500 annual report/return does not adequately provide an accurate and meaningful measure of a plan's funding status. Under the Administration's proposal, all single-employer defined benefit plans covered under the Pension Benefit Guaranty Corporation (PBGC) with more than 100 participants, and required to make quarterly contributions for the plan year, would be required to file a Schedule B with their Form 5500 by the fifteenth day of the second month following the close of the plan year (if calendar year, February 15). Where a contribution is subsequently made for the plan year, an amended Schedule B would be required to be filed under the Form 5500's existing requirements.[2] Under the Administration's proposal, these plans would be required to use a beginning of plan year valuation.[3]

ASPPA recognizes that while some accelerated information would be helpful to provide an early warning system to protect the PBGC, an expanded exemption from the new Schedule B filing requirement should be made for small to medium-sized plans, similar to the Administration's exemption for plans subject to the at-risk liability calculation based on a plan sponsor's financial health. An earlier reporting requirement for many small to medium-sized plans that do not pose a potential risk to the PBGC would unnecessarily increase administrative complexity and costs. In addition, requiring an earlier valuation date for certain small to medium-sized plans not subject to Administration's accelerated filing date would further expand an unnecessary administrative burden on these plans.

ASPPA recommends that only plans with 500 or more participants that are required to make quarterly contributions be required to file a report on the funded status of the plan within 90 (ninety) days after the close of the plan year (if calendar year, March 31). This reporting would be done using a newly-created form Schedule B–1 (which would be filed electronically, if possible) and would provide only the asset and liability information necessary to disclose the plan's funded status as of the valuation date in the prior plan year (retaining the current law structure of allowing any plan valuation date in a plan year.) Any additional reporting information, such as the annual contribution information, should continue to be reported on the regular Schedule B filed with the Form 5500. In addition, we recommend that plans not subject to the Administration's accelerated filing date with less than 500 participants be allowed to retain the current law structure of allowing any valuation date.

Consistent with the interests of the Administration, this new Schedule B–1 would allow the dissemination of more accurate and timely information regarding the funded status of a plan, without causing a substantial administrative or financial hardship on small to medium-sized plans that pose little potential risk to the PBGC.

*The Impact of Fluctuating Interest Rates on Lump Sum Calculation*

As sponsors of defined benefit plans promise a guaranteed benefit to their participants, a plan sponsor must calculate on a year-by-year basis the extent to which contributions are required to fund those promised benefits. Under current law, when a benefit will be paid in the form of a lump sum a common occurrence for defined benefit plans—the calculation of the annual contribution requirements consists of several elements. First is the requirement that a promised benefit not exceed a specified amount (the "415 limit")[4], which is expressed in terms of a life annuity. Second, if a participant in a defined benefit plan elects benefit payment in a form other

[2] Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due seven months after the end of the plan year (if calendar year, July 31), with a two and a half month extension available (if calendar year, October 15).

[3] Under current law, defined benefit plans are allowed to use any valuation date of a plan year for disclosure purposes.

[4] The annual benefit limit under IRC 415 (the "415 limit") is the lesser of (1) 100 percent of the participant's average compensation over the highest three consecutive years, or (2) $160,000 (indexed for inflation), expressed in terms of a life annuity beginning at age 65.

than a life annuity (e.g., lump sum, term certain), the 415 limit must be converted to reflect this alternative form of benefit.

Prior to 1995, the interest rate assumption generally used when making this conversion was 5 percent. Thus, for example, the 415 limit for a lump sum distribution could be determined mathematically in advance of the participant's retirement. This permitted an employer to know exactly, upon performance of a relatively simple calculation, what its annual plan contribution obligations would be. This was particularly crucial for smaller defined benefit plans, since the payout to even one single participant can have a dramatic impact on overall plan funding, and thus on annual contribution obligations.

From 1995 to 2003, the 415 limit for forms of benefit other than a life annuity was determined by using the 30-year Treasury bond rate, which produced a fluctuating month-to-month interest rate. The Pension Funding Equity Act of 2004 (PFEA "04) amended IRC 415 to provide that for plan years beginning in 2004 or 2005, an interest rate assumption of 5.5 percent was to be used in lieu of the applicable interest rate. This temporary interest rate assumption was a welcome relief to smaller defined benefit plans, as it provided much needed simplicity and predictability in making lump sum calculations.

The Administration's proposal, while not expressly addressing the 415 issue, does not appear to extend this 5.5 percent interest rate assumption in determining the 415 limit for lump sum calculations. Instead, the proposal seems to contemplate that the contribution amount to fund a lump sum payment subject to the 415 limit be calculated by using interest rates drawn from a zero-coupon corporate yield curve.

The complexity of the yield curve calculation would create a significant volatility problem facing small and medium-sized defined benefit plan sponsors. Using the yield curve to determine funding obligations for the 415 limit based on monthly fluctuating interest rates would make it very difficult for smaller businesses to properly fund their plans and virtually impossible to project funding obligations into future years. It would create confusion to plan sponsors and plan participants whose lump sum payment amounts may bounce up and down as these rates change. It would also cause plans to be unable to reasonably determine their liabilities with regard to benefits payable in a lump sum and other forms of payment.

Affordability issues are also raised a plan sponsor will justifiably wonder whether it will be able to afford to guarantee the defined benefit. There would be a chilling effect on a plan sponsor's willingness to establish a plan because of the impossibility of predictability for the plan's obligations. The problems arising from being wholly dependent on the whims of a widely-fluctuating interest rate would be a major deterrent to the establishment of defined benefit plans, especially for small businesses.

In order to provide for a more predictable funding requirement for small defined benefit plans, ASPPA recommends that the use of the current 5.5 percent interest rate assumption for benefit forms other than a life annuity (i.e., lump sums) for purposes of the 415 limits as set forth in PFEA "04 be made permanent. This use of a flat interest rate would remove the volatility from the determination of lump sums and other form of benefits, ensure consistency for planning purposes, pave the way for the potential establishment of new defined benefit plans by small businesses, and be no more generous than current law.

*Reduced PBGC Premiums for Small and New Plans*

Finally, while ASPPA agrees that some reform of the PBGC premium structure is necessary to increase the PBGC revenue needed to meet expected claims and improve their underlying financial condition, an exception from the Administration's proposed fixed and risk-based premium (which would replace the current Variable Rate Premium) should be created for small and new defined benefit plans that pose no significant risk to the PBGC. These plans expose the PBGC to little, if any, liability, and accordingly should be charged minimal premiums.

The Administration's defined benefit reform proposal would increase the current fixed rate to reflect the cost of living adjustment (COLA) from 1991, and index the fixed premium thereafter. The Administration would also assess a new risk-related premium on all plans with assets less than their funding target. While the premium rate per dollar of underfunding would be identical for all plans, the Administration has, however, suggested an unorthodox system that would allow this premium rate per dollar of underfunding to be set, reviewed, and revised periodically by the PBGC Board. The Administration represents that these premium increases are necessary to mitigate future losses and retire PBGC's deficit (currently valued at $23 billion) over a reasonable time period.

This new premium structure would create a great deal of uncertainty for plan sponsors every year in budgeting for PBGC premiums. Further, with unprecedented

authority being provided to the PBGC Board to set the risk-related premium, there is a potential that these premiums could unnecessarily escalate for certain plan sponsors who do not pose a significant risk to the PBGC, under the pretext of decreasing the PBGC deficit. It would not only force many plan sponsors, especially small to medium-sized companies, to exit the system, it would also restrict the creation of new plans and future PBGC premium-payers.

ASPPA recommends that an exception be provided to small and new plans from these proposed PBGC premium reforms. These two non-controversial exceptions have been introduced by Congressional lawmakers in prior legislation. Most recently, they were included in the Senate Finance Committee's reintroduced pension protection legislation, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act, introduced by Committee Chairman Charles Grassley (R–IA) and ranking member Max Baucus (D–MT) on January 31, 2005. They were also included in the House pension reform bill, the Pension Security Act of 2004 (H.R. 1000), introduced in the 108th Congress by House Committee on Education and the Workforce Chairman John Boehner (R–OH) and passed by the House on May 14, 2003.

ASPPA proposes for new small plans [5] (maintained by controlled group with 100 or fewer employees), that the premium for each of the first five years of existence be set at $5 per participant with no risk-related premium owed. For new plans that have over 100 participants, the PBGC premium should be phased in at a variable rate over the first five years (20 percent for first year, 40 percent for second year, and so on).

Further, for very small plans (maintained by controlled groups with 25 or less employees), ASPPA proposes to either: (1) cap their variable rate premium payments for each participant to an amount equal to $5 times the number of plan participants; or (2) allow the exclusion of substantial owner benefits in excess of the phased-in amount from their variable rate premium calculations.

*Conclusion*

ASPPA appreciates the opportunity to offer its perspective on these very important defined benefit reform issues. We believe any new reforms should be designed to stimulate and protect the defined benefit system. ASPPA looks forward to working with the Committee and the Administration on a comprehensive solution to defined benefit reform.

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**Letter from the Food Marketing Institute, Submitted for the Record**

March 2, 2005

The Honorable John Boehner, Chairman
Committee on Education and the Workforce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Boehner:

The Food Marketing Institute (FMI), on behalf of the nation's neighborhood grocery stores, respectfully submits this letter for your hearing record. FMI represents supermarkets and food wholesalers employing 3.5 million associates.

We agree that it is an important time to reform the defined benefit pension system. We respectfully request that your Committee's review cover defined benefit multiemployer plans, as well as single employer plans. The former play an important role in providing retirement benefits for almost 10 million American workers and the laws governing their sound operation need to be revised and updated. We look forward to working with you and your Committee to resolve the fiscal crisis currently facing all defined benefit plans.

Sincerely,

John J. Motley III
Senior Vice President
Government and Public Affairs

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[5] A new plan means a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as in the new plan.

**Statement of Alan Reuther, Legislative Director, International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW), Submitted for the Record**

INTRODUCTION

This testimony is submitted on behalf of the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, (UAW), in connection with the hearing scheduled for March 2, 2005 by the Committee on Education and the Workforce on the subject of The Retirement Security Crisis: The Administration's Proposal for Pension Reform and its Implications for Workers and Taxpayers.

The UAW represents 1,150,000 active and retired employees in the automobile, aerospace, agricultural implement and other industries. Most of our active and retired members are covered under negotiated single employer defined benefit pension plans (hereafter referred to as "pension plans").

The UAW has a long and proud history of involvement in legislation relating to these pension plans. We were in the forefront of the decade long struggle to enact ERISA, which led to the establishment of the PBGC. We also were actively involved in the enactment of legislation in 1987 and again in 1994 to strengthen the funding of pension plans and the PBGC.

The UAW believes Congress once again needs to adopt balanced proposals that will strengthen the funding of pension plans and encourage employers to continue these plans. We also support new measures to bolster the PBGC and the security of pension benefits for workers and retirees.

Unfortunately, the package of proposals advanced by the Administration will not achieve these objectives. In our judgment, the Administration's pension proposals are dangerous and counterproductive. They would punish employers who are already experiencing financial difficulties, resulting in more pension plan terminations and loss of retirement benefits, more bankruptcies, plants closings and layoffs, more liabilities being dumped on the PBGC, and more employers choosing to exit the defined benefit pension system. As a result, these proposals would be bad for employers, bad for workers and retirees, bad for the PBGC and bad for the entire defined benefit pension system.

The UAW urges the Committee on Education and the Workforce to reject the Administration's proposals, and instead to put forward a bipartisan package of proposals that will improve the funding of pension plans and bolster the PBGC, without punishing employers, workers and retirees. We stand prepared to work with the Committee to achieve these objectives.

*I. Strengthening the Funding of Pension Plans*

The UAW supports balanced legislation to strengthen the funding of pension plans. These reforms should be designed to ensure that benefits promised by employers to workers and retirees are adequately funded, thereby improving the security of these benefits and also reducing the PBGC's exposure for unfunded pension liabilities.

However, the UAW believes it is imperative that any new funding rules should be structured so as to provide predictable, stable funding obligations for employers and to reduce the volatility of required contributions from year to year. New funding rules should also encourage employers to contribute more than the bare minimum in good times, and avoid counter-cyclical requirements that punish employers during economic downturns.

Unfortunately, the funding proposals advanced by the Administration fail to meet these common sense objectives. The UAW strongly opposes the Administration's funding proposals because they would result in highly volatile pension funding obligations, would reduce incentives for employers to contribute more than the bare minimum, and would punish employers who are already experiencing economic difficulties.

*A). Interest Rate Assumption*

The UAW strongly opposes the Administration's proposal to require employers to use a so-called yield curve in establishing the interest rate assumption for pension plans. Under this proposal, the interest rate would be based on a near-spot rate (averaged over only 90 days), with a different interest rate being applied to each payment expected to be made by the plan based on the date on which that payment will be made.

This proposal has a number of fundamental problems. First, it would be extremely complicated, imposing considerable administrative burdens on plan sponsors. These

burdens may discourage employers from continuing defined benefit pension plans (especially small- and mid-sized companies).

Second, contrary to the Administration's assertions, the yield curve would not provide greater "accuracy" in setting the interest rate assumption. Because there is no real market for corporate bonds of many durations, these interest rates would largely be fictitious.

Third, the yield curve would result in highly volatile funding requirements that would fluctuate widely as interest rates change over time. This increased volatility would create enormous difficulties for employers, who need stability and predictability in their funding obligations. Indeed, the increased volatility would be a powerful incentive for employers to exit the defined benefit system.

Fourth, the yield curve would impose higher funding obligations on older manufacturing companies that have larger numbers of retirees and older workers. As a result, it would exacerbate the competitive disadvantage that many of the companies currently have because of heavy legacy costs, and would punish companies that are already experiencing economic difficulties.

Instead of this dangerous and counterproductive yield curve proposal, the UAW urges the Committee on Education and the Workforce to make permanent the long term corporate bond interest rate assumption that was included in the temporary legislation enacted by Congress last year. In our judgment, this long term corporate bond interest rate assumption would provide an economically sound and accurate basis for valuing pension liabilities, would be administratively simple for plan sponsors to implement, would result in stable and predictable funding obligations for employers, and would avoid imposing unfair, counter-cyclical funding burdens on older manufacturing companies.

At the same time, the UAW urges the Committee on Education and the Workforce to allow employers to use collar-adjusted mortality tables in valuing their plan liabilities. This would enable employers to more accurately value the future benefit obligations, especially for older manufacturing companies with larger numbers of retirees and older workers.

*B). Improving Plan Funding*

The UAW strongly opposes the Administration's proposal to throw out the existing funding rules in their entirety, and to replace them with new funding rules based on spot valuations of assets and liabilities, with no smoothing mechanisms, and with funding targets tied to a company's credit rating. These changes would introduce an enormous element of volatility into pension funding requirements. This would make it much more difficult for companies to plan their cash flow and liability projections, and thus would provide yet another powerful incentive for employers to exit the defined benefit pension system. In addition, these changes would punish companies that are already experiencing economic difficulties and have poor credit ratings by imposing sharply higher funding obligations on these employers. The net result could be more bankruptcies, job loss and plan terminations, with even more unfunded liabilities being transferred to the PBGC.

Instead of this counterproductive approach, the UAW urges the Committee on Education and the Workforce to support changes in the existing deficit reduction contribution (DRC) rules that would lead to improved funding of pension plans, but also provide smoother, more predictable funding obligations for employers and less onerous, counter-cyclical burdens on employers experiencing a temporary downturn. We believe this could be accomplished through two changes: (1) modifying the trigger for the DRC so that it applies to a broader universe of plans, and also is triggered more quickly when a plan becomes less than fully funded; and (2) reducing the percentage of the funding shortfall that must be made up in any year, so there will be a smoother path towards full funding. These changes would help to ensure that more employers are required to make up funding shortfalls in their plans, and are required to begin taking this action sooner. At the same time, these changes would avoid wild swings in a company's funding obligations that can have negative, counter-cyclical effects, especially on employers who are already experiencing economic difficulties.

The UAW also urges the Committee on Education and the Workforce to adopt changes to the general ERISA funding rules to shorten the amortization period for plan amendments from 30 to 15 years. This would bring this amortization period more in line with the average remaining working life of most participants. It would require more rapid funding of benefit improvements, and thereby help to improve the overall funding of pension plans.

Finally, the UAW supports modifying the definition of "current liability" to take into account lump-sum distributions reasonably projected to be taken by plan participants. This would require plans to provide adequate funding to cover anticipated

lump sum distributions, and help to prevent situations where plans have been drained because of such distributions.

*C). Credit Balances*

The UAW strongly opposes the Administration's proposal to completely eliminate credit balances, which are currently created when an employer contributes more than the minimum required under existing funding rules. By eliminating credit balances entirely, the Administration's proposal would have the perverse effect of discouraging companies from contributing more than the bare minimum during good economic times. This, in turn, could make the funded status of pension plans even worse.

Instead of this counterproductive approach, the UAW urges the Committee on Education and the Workforce to modify the existing rules regarding credit balances on a prospective basis, so that employers are required to value new credit balances according to the actual market performance of the extra amounts contributed by the employer. This would eliminate problems that have arisen when the actual market performance diverges from plan assumptions. But it would still preserve the important incentive that credit balances provide for employers to contribute more than the minimum required under the funding rules.

The UAW also supports increasing the deduction limit from 100 percent to 130 percent of current liability. This would allow employers to contribute more during good economic times, and to build up a bigger cushion to help during economic downturns.

In addition, the UAW supports modifying the current rules on the use of excess pension assets, so that employers are allowed to use these assets for health care expenditures for active and retired employees, not just for retirees. This would provide yet another incentive for employers to better fund their pension plans during good economic times, by providing greater assurance that companies can always benefit economically from surplus pension assets.

*D). Limits on Benefits*

The UAW strongly opposes the Administration's proposals to place strict, arbitrary limits on benefits provided by pension plans that are less than 100 percent funded. These proposals would have a sharply negative impact on workers and retirees. In effect, they would reduce the adequacy of retirement benefits provided by pension plans to tens of thousands of workers and retirees. We are particularly troubled by the Administration's proposals to freeze benefit accruals, which would have an especially devastating impact on workers and their families.

The UAW is also outraged by the Administration's radical proposal to prohibit pension plans from even offering plant-closing benefits. These types of benefits have been an important means of cushioning the economic impact of plant closings as companies struggle to reorganize. By making it possible for more workers to retire with an adequate income, these benefits reduce the number of workers who have to be laid off and wind up drawing unemployment insurance and retraining benefits. It makes no sense, therefore, to prohibit plans from even offering this type of benefit.

The UAW also is concerned about the discriminatory impact of the Administration's proposals on blue-collar workers and retirees covered under so-called flat dollar plans. It is patently unfair to place restrictions on benefit improvements in flat dollar plans where the parties simply attempt to adjust benefits in accordance with the growth in wages, but to allow the benefit improvements that occur automatically in salary related plans for white collar and management personnel. In our judgment, any proposals should treat both types of plans in an even-handed manner.

Contrary to the impression created by the Administration, current law does not allow employers and unions to "conspire" to increase benefits without regard to the funded status of a pension plan, and to then terminate the plan and dump these unfunded benefit promises onto the PBGC. By virtue of the five-year phase in rule, the PBGC may not fully guarantee all benefit improvements preceding a plan termination. Thus, so-called "death bed" benefit increases are not guaranteed and do not result in any increase in the PBGC's liabilities.

The UAW does recognize that pension plans that are less than fully funded have experienced problems with the payment of lump sum distributions. In some cases, the payment of lump sums has drained assets from these plans, unnecessarily jeopardizing the continuation of the plans and the payment of benefits to other participants and beneficiaries. Thus, the UAW would support reasonable limitations on the payment of lump sums in such plans.

In addition, the UAW supports the enactment of a new "plan reorganization" process for underfunded plans in situations where the employer has filed for Chapter

11 bankruptcy reorganization. We believe that this type of process could provide better flexibility in the adjustment of benefits and funding obligations, and thereby enable more companies in financial distress to continue their pension plans. This would be beneficial for the participants and beneficiaries because it would allow them to still have their pension plan and to keep some benefits that would otherwise be lost in the event of a plan termination. At the same time, this would be beneficial for the PBGC because it would require the employer to continue making some contributions to the plan and prevent the unfunded liabilities from being transferred to the PBGC. Employers would also benefit from this plan reorganization option because it would provide greater flexibility in adjusting benefits and funding obligations, so that continuation of the pension plan becomes manageable.

To make sure that this plan reorganization process is not abused, the UAW believes it should only be available to employers that have already taken the difficult step of filing for Chapter 11 bankruptcy reorganization. Furthermore, the bankruptcy court should be empowered to approve benefit and funding modifications beyond those already permitted under current law only if they are approved by all of the stakeholders: that is, by the PBGC, the employer, and union (or, in the case of non-represented participants, an independent fiduciary appointed by the bankruptcy court). Finally, the permissible benefit modifications should be restricted to non-guaranteed benefits that would be lost anyway in the event of a plan termination. Permissible funding modifications should extend to thirty-year amortization of existing unfunded liabilities.

The UAW believes that this type of plan reorganization process could be a powerful tool for enabling struggling employers to continue their pension plans, while protecting workers and retirees to the maximum extent feasible, and also reducing the exposure of the PBGC. This process could provide the flexibility that is needed to address different economic situations that are presented in Chapter 11 cases, rather than the one-size fits all approach proposed by the Administration.

*E). Cash Balance Plans*

The UAW believes that traditional defined benefit pension plans are better for workers and retirees than cash balance plans. At the same time, we recognize that cash balance plans are better than defined contribution plans or no pension plan at all. In recent years, the UAW has negotiated cash balance plans to cover new employees at Delphi, Visteon and other auto parts companies. This recognizes the difficult economic situations facing domestic producers in this industry.

Unfortunately, the continuing legal uncertainty concerning cash balance plans is causing some employers to shift to defined contribution plans or not to offer any pension plan at all. This was vividly demonstrated by the recent announcement by IBM that it would only provide a defined contribution plan for future employees. This trend is disturbing, both because it is bad for the future retirement income security of workers and retirees, and because it could further undermine the premium base for the PBGC.

For these reasons, the UAW supports legislation to resolve the legal uncertainties surrounding cash balance plans, by making it clear that they are not per se a violation of age discrimination laws. We also support allowing greater flexibility for cash balance plans in setting interest credits. At the same time, in situations where a traditional defined benefit plan is converted to a cash balance plan, we believe reasonable transition relief should be provided to older workers who are near retirement. This combination of reforms would protect the legitimate retirement expectations of older workers, while at the same time allowing employers to remain in the defined benefit pension system (and continuing paying premiums to the PBGC) through the vehicle of cash balance plans.

*II. Pension Benefit Guaranty Corporation (PBGC)*

It is important, at the outset, to underscore that there is no "crisis" at the PBGC. As the Administration has admitted, the PBGC has sufficient assets to pay all guaranteed benefits for many years to come (at least until 2020, and possibly longer). Thus, the reports about the PBGC's growing deficit should not create a stampede towards extreme, counterproductive proposals. Congress should approach this issue in a deliberative manner, and make sure that any remedies do not cause more harm to workers, retirees, employers and the defined benefit pension system.

There is no mystery about what has caused the PBGC to have a growing deficit. In the recent past the PBGC was projecting a significant surplus. But bankruptcies in the steel industry led to the terminations of a number of pension plans with the largest unfunded liabilities ever assumed by the PBGC. Now, bankruptcies in the airlines industry are threatening to result in plan terminations with even bigger unfunded liabilities. Thus, there is no dispute that the PBGC's deficit is directly attrib-

utable to the widespread economic difficulties and bankruptcies in the steel and airline industries.

Unfortunately, the Administration has come forward with three dangerous and counterproductive proposals to address the PBGC's projected deficit. In our judgment, these proposals would unfairly punish workers and retirees. They would also punish employers who are already experiencing economic difficulties, leading to more bankruptcies and job loss, as well as more plan terminations. Moreover, these proposals would encourage employers to exit the defined benefit system, increasing the danger of even bigger pension liabilities being transferred to the PBGC.

*A). Premium Increases*

The UAW opposes the Administration's proposal to drastically increase the flat premium paid by all sponsors of single employer defined benefit pension plans from $19 to $30, and to index the premium for future increases in wages. We also oppose the Administration's proposal to impose a huge increase in the variable rate premium charged to employers that sponsor plans that are less than fully funded, and to have the amount of this variable rate premium vary depending on the credit rating of a company.

First, the magnitude of these premium increases would impose significant economic burdens on many companies. This would be especially hard on companies that are already experiencing economic difficulties and on medium-sized and small businesses. It would also exacerbate the competitive disadvantage for many older manufacturing companies with large legacy costs.

Second, the change in the structure of the variable rate premium–specifically, linking it to a company's credit rating–would have the perverse affect of punishing companies that are already in difficult economic situations. Again, this would exacerbate the competitive disadvantage facing many older manufacturing companies.

In light of these factors, the UAW believes the Administration's premium proposals would be counterproductive. At a minimum, these proposals would encourage an exodus of employers from the defined benefit pension system. This could undermine the retirement income security of millions of workers and retirees. It would also narrow the premium base for the PBGC, and thereby increase its financial difficulties. In the end, there is a real danger that the PBGC and the defined benefit pension system could enter into a death spiral, with a constantly shrinking premium base and growth in the pension liabilities being transferred to the PBGC.

*B). PBGC Guarantees*

The UAW opposes the Administration's proposals to cut the PBGC guarantees. These include freezing the guarantees when an employer files for Chapter 11 bankruptcy, and effectively eliminating any guarantee for plant closing benefits. These changes would unfairly punish tens of thousands of workers and retirees, reducing their retirement benefits and leaving them with a sharply reduced standard of living.

It is important to emphasize that, under current law, workers and retirees often lose a portion of their benefits when a plan is terminated. Because of the five-year phase in rule and other limits, workers and retirees typically lose a portion of their benefits attributable to recent benefit improvements and certain early retirement benefits. The UAW believes that these benefit losses should not be made worse by further reductions in the scope of the PBGC guarantees.

*C). PBGC Lien for Unpaid Contributions*

The UAW opposes the Administration's proposal to give the PBGC a lien in bankruptcy proceedings for any unpaid pension contributions. This would punish troubled companies and their retirees, and lead to more liquidations, lost jobs and lost retiree health benefits. It could also result in more plan terminations and even greater pension liabilities being transferred to the PBGC.

Companies do not lightly take the step of filing for Chapter 11 bankruptcy. They do so only when they are experiencing significant economic difficulties and are unable to pay all debts when due. Chapter 11 bankruptcy, by definition, is a zero sum situation. To the extent one creditor is given a higher priority or greater claim on the company's assets, this necessarily means that the other creditors will receive less.

Thus, granting the PBGC a lien against a company's assets for any unpaid pension contributions necessarily means that other creditors–lending institutions, suppliers and other vendors, and the workers and retirees–would recover less. This would inevitably trigger a number of counterproductive, harmful consequences.

First, lenders would be more reluctant to provide the financing that is critically important to ensuring the successful reorganization of companies in Chapter 11 proceedings. Without this financing, there would be more liquidations and hence more

job loss. Even worse, the negative ramifications on the lending community would extend to companies that have not yet filed for Chapter 11 bankruptcy, but who are experiencing economic difficulties and are potential candidates for Chapter 11. To protect themselves, lenders would be forced to charge higher costs to these troubled companies or even refuse financing. The end result could be more bankruptcies, and even more job loss.

Second, retirees would be particularly hard hit by any PBGC lien for unpaid pension contributions, since this would significantly reduce their ability to collect on claims for retiree health insurance benefits. In many of the Chapter 11 cases where there is an underfunded pension plan, the single biggest group of unsecured creditors are the retirees with their claim for health insurance benefits. If the PBGC is given a lien for unpaid pension contributions, the practical result would often be that there are no assets left to provide any retiree health insurance benefits. Thus, the net result of increasing the PBGC's recovery would be to punish the retirees—the very people the PBGC was created to protect.

Third, other suppliers and vendors would also be negatively impacted by the granting of a lien to the PBGC for unpaid pension contributions. In many bankruptcies, this means that these other businesses would get a significantly reduced recovery for their claims. This could jeopardize their ability to continue in business, leading to a chain reaction of more bankruptcies and job loss.

Fourth, it is highly questionable whether the PBGC would ultimately benefit by being granted a lien for unpaid pension contributions. To the extent this proposal forces more companies to liquidate more quickly, there would be more plan terminations and even more pension liabilities transferred to the PBGC.

The PBGC already has significant leverage in bankruptcy proceedings because of the enormous claims it has for unfunded liabilities, and because of its ability to affect the timing and other aspects of plan terminations. There is simply no need to increase the PBGC's leverage, to the detriment of workers, retirees, employers, and the entire defined benefit pension system.

*D). A Positive Approach to Strengthening the PGGC*

Instead of the harmful, counterproductive proposals advanced by the Administration, the UAW believes that the PBGC can be strengthened through a number of approaches that would protect the interests of workers and retirees, employers and the entire defined benefit pension system.

First, the UAW believes that the overall funding of pension plans can be strengthened through the reforms we have previously supported in Section I of this testimony. By taking steps now to improve the funding of pension plans, Congress can improve the security of benefits for workers and retirees, and also reduce the long-term exposure of the PBGC. These reforms can also encourage employers to continue defined benefit pension plans, while avoiding counterproductive burdens on employers who are experiencing economic difficulties.

Second, the UAW believes that the plan reorganization process discussed previously in Section I of this testimony can be especially helpful in reducing the number of bankruptcy cases that lead to pension plan terminations and liabilities being transferred to the PBGC. In particular, we believe this type of process could be important immediately in providing the flexibility necessary for United and other airlines to continue their pension plans, instead of terminating them. This would significantly reduce the PBGC's deficit, by keeping these airline pension liabilities from being transferred to the PBGC. It would also benefit the workers and retirees at these airline companies, by keeping their pension plans going and allowing them to receive greater benefits than they would if the plans were terminated. At the same time, this reorganization process could provide significant economic relief to the troubled airlines, while still requiring them to continue some level of pension contributions. The same combination of factors could also make this type of reorganization process helpful in other industries, thereby reducing the PBGC's future exposure for pension liabilities.

Third, the UAW believes that the best way to deal with the steel and airline pension liabilities that have already or will soon be assumed by the PBGC is to have the federal government finance these liabilities over a thirty year period. This could be accomplished by having the federal government (or the PBGC) issue thirty-year bonds, and then have the federal government pay the interest on these bonds as it comes due. We believe this approach would cost the federal government about $1–2 billion per year, depending on the magnitude of the airline pension liabilities that are ultimately assumed by the PBGC.

The UAW recognizes that the federal government is already running substantial budget deficits. But this infusion of federal funds to strengthen the PBGC can easily be afforded by our nation. For example, in its current budget, the Administration

has proposed significant increases in the amounts that individuals can contribute to various individual retirement and savings accounts (so-called RSAs and LSAs). This involves a substantial tax expenditure that will flow overwhelmingly to upper income individuals. The Congressional Research Service has estimated that this proposal will cost the equivalent today of $300 to $500 billion over ten years. The UAW submits that these funds could better be used to strengthen the PBGC and protect the retirement benefits of average working families in defined benefit pension plans.

Whatever the difficulties, the fact remains that using general revenues to gradually finance the PBGC's steel and airline related pension deficit is better than all of the other options currently being considered. Specifically, it is better than punishing workers and retirees by cutting the PBGC guarantees. It is better than punishing companies that sponsor pension plans by drastically increasing their PBGC premiums. And it is better than punishing companies that are experiencing financial distress by giving the PBGC a greater claim in bankruptcy proceedings. These other options will inevitably hurt workers and retirees and employers that sponsor pension plans. They will also lead to more bankruptcies and job loss. And they will drive employers away from the defined benefit pension system, creating a death spiral for the PBGC.

The truth is the PBGC was never designed to handle widespread bankruptcies and pension plan terminations across entire industries, as we have seen in steel and are now witnessing in airlines. Indeed, the seminal case that led to the creation of the PBGC was the Studebaker situation, in which a single auto company went out of business and terminated its pension plan. Obviously, the entire auto industry did not go bankrupt or terminate its pension plans then.

When the PBGC was created by Congress, it was modeled after the Federal Deposit Insurance Corporation (FDIC), which insures bank deposits for individuals. The FDIC was designed to handle isolated bank failures, not the collapse of a broad section of the banking industry. When the savings and loan crisis occurred in the 1980s, Congress wisely recognized that the costs associated with S & L failures should not be shifted onto the backs of individual depositors, nor onto the backs of other banking institutions. Congress recognized that those alternatives would impose unacceptable hardships on individuals and other banks, and would have a counterproductive impact on the rest of the banking system and our entire economy. As a result, Congress decided to have the federal government finance the S & L liabilities over many years, at a cost of hundreds of billions of dollars.

The same principles make sense in the case of the steel and airline pension liabilities that have or will be assumed by the PBGC. Shifting those costs onto workers and retirees or employers that sponsor pension plans would simply lead to unacceptable hardships and counterproductive economic consequences. The best approach–for workers and retirees, for employers that sponsor pension plans, for troubled companies and for our entire economy–is to spread those costs gradually and broadly across society by having the federal government finance them over thirty years.

This approach would not reward "bad actors". The steel and airline bankruptcies and pension plan terminations were caused by many factors, including the policies (or non-policies) of the federal government relating to trade, deregulation, energy and health care, as well as the shocks flowing from the terrorist attacks on September 11th. In our judgment, it is entirely appropriate to now ask the federal government to help pay for the pension costs flowing from those policies and events.

Indeed, Congress already endorsed this notion in a more limited context. In the Trade Act of 2002, Congress provided for a new 65 percent tax credit to pay for retiree health benefits for retirees whose pension plans have been terminated and taken over by the PBGC, and who are between the ages of 55–65. Through this provision, Congress effectively used general revenues to pay for part of the costs associated with providing retiree health benefits to this group of retirees. This provision was designed primarily as a response to the bankruptcies (and pension plan terminations) in the steel industry, which had resulted in thousands of steelworker retirees losing their health benefits. It reflected a recognition by Congress that our trade and health care policies had played a role in the steel company bankruptcies and the loss of retiree health benefits. The UAW submits that the same principles now justify using general revenues to pay for the pension costs flowing from the steel and airline bankruptcies and plan terminations.

Similarly, Congress has a long history of using general revenues to respond to disasters across our nation. This includes floods, hurricanes, droughts and many other types of catastrophes. The UAW submits that the devastation that has occurred in our steel and airlines industries is no less worthy of federal assistance.

There is no danger this type of approach will create a "moral hazard" leading to worse pension funding and more problems in the future. This is because the UAW is proposing that the infusion of general revenues to pay for the airline and steel

pension liabilities be coupled with the package of reforms to strengthen the funding of other pension plans and with the new plan reorganization process that will help troubled companies to continue their pension plans and reduce the future exposure of the PBGC.

## CONCLUSION

The UAW appreciates this opportunity to submit testimony to the Committee on Education and the Workforce to express our views on the Administration's proposals relating to the funding of pension plans and the financial status of the PBGC. We urge the Committee to reject the Administration's harmful and counterproductive proposals, and instead to fashion a constructive package that will strengthen the funding of pension plans, protect workers and retirees, provide stability and predictability to employers that sponsor pension plans and encourage them to remain in the defined benefit pension system, and place the PBGC on a sound and sustainable path.

We look forward to working with Members of the Committee on Education and the Workforce as you consider these important pension issues. Thank you.