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PBGC REFORM: MENDING THE PENSION SAFETY NET

HEARING

BEFORE THE

SUBCOMMITTEE ON RETIREMENT SECURITY AND AGING

OF THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINING PROPOSALS TO REFORM THE PENSION FUNDING RULES AND PREMIUMS PAYABLE TO THE PENSION BENEFIT GUARANTY CORPORATION

APRIL 26, 2005

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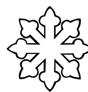

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C O N T E N T S

STATEMENTS

TUESDAY, APRIL 26, 2005

	Page
DeWine, Hon. Mike, Chairman, Subcommittee on Retirement Security and Aging, opening statement	1
Mikulski, Hon. Barbara A., a U.S. Senator from the State of Maryland, opening statement	2
Prepared statement	2
Belt, Bradley, Executive Director, Pension Benefit Guaranty Corporation, Washington, DC	3
Prepared statement	6
Enzi, Hon. Michael B., Chairman, Committee on Health, Education, Labor, and Pensions, prepared statement	12
MacFarlane, Ian, Market Strategist, Medley Global Advisors, New York, NY; Sallie Ballantine Bailey, Senior Vice President-Finance and Controller, the Timken Company, Canton, OH; Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries, Washington, DC; and Alan Reuther, Legislative Director, United Auto Workers, Washington, DC	15
Prepared statements of:	
Mr. MacFarlane	17
Ms. Bailey	21
Mr. Gebhardtsbauer	31
Mr. Reuther	33

ADDITIONAL MATERIAL

Statements, articles, publications, letters, etc.:	
Kennedy, Hon. Edward M., a U.S. Senator from the State of Massachussetts	50
Response to question of Senator Kennedy by Ron Gebhardtsbauer	51
Response to questions of Senator Kennedy by Bradley Belt	54
Response to questions of Senator Mikulski by Bradley Belt	58
Prepared statement of the National Rural Electric Cooperative Association	59

PBGC REFORM: MENDING THE PENSION SAFETY NET

TUESDAY, APRIL 26, 2005

U.S. SENATE,
SUBCOMMITTEE ON RETIREMENT SECURITY AND AGING, OF THE COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in Room 430, Dirksen Senate Office Building, Hon. Mike DeWine, chairman of the subcommittee, presiding.

Present: Senators DeWine, Enzi, Isakson, and Mikulski.

OPENING STATEMENT OF CHAIRMAN DEWINE

Senator DEWINE. Good morning. I would like to welcome everyone to the first hearing of the Subcommittee on Retirement Security and Aging. I look forward to an active hearing schedule, both in the area of pensions and in aging issues. I also look forward to working with Ranking Member Mikulski again. The Senator and I have worked together in the past and have a great relationship, and Barbara, I look forward to working with you again. We worked together on aging issues in the 106th Congress when we collaborated together on the reauthorization of the Older Americans Act.

Today, we will be looking at the Pension Benefit Guaranty Corporation, the agency charged with insuring the defined benefit pension plans. The agency's deficit sits at $23 billion right now and there have been some spectacular pension plan failures in recent years that have greatly worsened its financial position. The administration has proposed a combination of higher premiums to be paid by plan sponsors and higher funding standards as a means of reducing the under-funding in the system.

With this hearing, we will address several questions. What is the correct level to which we should increase the PBGC premiums, what is the optimal level of increased funding that will result in better funded plans without forcing the plan sponsors to abandon their plans or declare their bankruptcy and yet protect the financial integrity of the PBGC? I stress that last phrase, protect the financial integrity, because a taxpayer bailout is simply not an option.

We will hear first from Mr. Bradley Belt, Executive Director of the PBGC. We welcome you this morning and look forward to your testimony.

Mr. BELT. Thank you, Mr. Chairman.

Senator DEWINE. Barbara, let me move—before we get to your testimony—to Senator Mikulski for her comments. Barbara, thank you very much.

OPENING STATEMENT OF SENATOR MIKULSKI

Senator MIKULSKI. Mr. Belt, just a few words. First of all, Senator, I want to thank you for holding this hearing and want to thank Senator Enzi for taking such a keen interest in the area of pensions and even changing the name of our subcommittee. Also, we want to thank his staff, the full committee staff, for also helping with the research.

Once again, I look forward to working with you. We were the ones that finally reauthorized the Older Americans Act, so we are a kind of "get it done" team here, and I particularly cherish the relationship because of your collegiality and civility, and we are Northeast-Midwest Corridor Senators. Both Senator DeWine and I come from States that have had a manufacturing base. We know that these companies now are either challenged or teeter-tottering, and some have either faded away or filed bankruptcy.

America faces a challenge, particularly in its manufacturing area, about what happens when corporations or companies for a variety of reasons can no longer take care of their pension responsibilities. We saw it firsthand in Maryland when Bethlehem Steel—Bethlehem Steel—closed and offshored its pension onto the PBGC. We are concerned that that could happen all over.

We know that the funding now is not a crisis, but it could come sooner than later and we need now to fully understand exactly what we need to do to shore up the solvency of the Pension Benefit Guaranty Corporation by first doing no harm, second, making sure we look out for those people who count on a pension plan, and later, whatever changes we make, we must make sure that we don't further exacerbate the problems that good guy business face in the new global economy.

Mr. Chairman, I would like my full statement to go into the record and look forward to the advice of these very able witnesses, and thank you.

Senator DEWINE. Senator, thank you very much.

[The prepared statement of Senator Mikulski follows:]

PREPARED STATEMENT OF SENATOR MIKULSKI

Introduction

Thank you to Chairman DeWine for holding this hearing. We look forward to hearing about the financial status of the Pension Benefit Guaranty Corporation, known as PBGC, and begin exploring ways to fix some of the problems they are having.

I know how important this is. PBGC is now insuring the pensions of over 40 million workers. These Americans are counting on their pension to be there when they retire. This is an important leg of the three-legged stool: pension, social security, and savings.

Maryland

This is especially important for Maryland. In 2002 when PBGC took over the pensions for Bethlehem Steel it was the largest pen-

sion plan ever assumed by the PBGC. While we appreciated the PBGC being there to guarantee the pensions for nearly 100,000 Bethlehem steel workers, many of whom lived in Maryland, there were also some problems encountered during the takeover. While it is important for the PBGC to be there to protect the pensions of Americans, we must also protect the businesses who have made the commitment to provide these pensions.

Current Problems Facing the PBGC

We know that the funding of the PBGC is not a crisis but a real problem that many American workers will face come 2040. It is important that we take steps to shore up the solvency of the Pension Benefit Guaranty Corporation, but we must first "do no harm."

Any steps we make should not come at the expense of our employer-provided pension system. We fully understand that employer provided pension plans are voluntary, not mandatory. Over 40 million Americans rely on the pension plans that the PBGC insures. If the rules governing such plans get too draconian, employers can discontinue their plans.

I worry that the administration's pension funding proposals does not balance the competing goals of improving the PBGC's finances and maintaining an environment that is conducive to employers continuing their pension plans.

For employees we need to make sure that pension promises made by employers are kept. Some PBGC funding rules may need to be changed but these promises are long-term commitments. For businesses, we must assure that short term difficulties don't result in long term problems, forcing companies to choose between continuing their pension plan and continuing their business. Solutions to address short-term funding difficulties must be balanced between the long-term solvency of the PBGC and the overall health of pensions in America.

Closing

I'm on the side of: (1) employees who are counting on promised pensions when they retire; (2) good guy businesses who have made the commitment and still provide pensions to their workers; and (3) taxpayers who shouldn't have to bail out the troubled PBGC.

I appreciate what a difficult task this is. I look forward to hearing from our witnesses today, getting the facts about the current status of the PBGC and exploring ways to improve it's solvency while protecting the pensions of America.

Senator DEWINE. Mr. Belt?

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

Mr. BELT. Mr. Chairman, Ranking Member Mikulski, thank you for the opportunity to appear before you this morning on such a vitally important issue. I appreciate the opportunity to discuss the challenges facing our Nation's defined benefit system and the administration's proposals to meet these challenges.

I would like to begin by asking the committee to envision a world in which defined benefit pension plans were fully funded. In such a world, workers and retirees would not lose promised benefits. Re-

sponsible companies would not have to pay higher pension insurance premiums. And taxpayers would not face the risk of a costly rescue of the Federal pension insurance program.

Unfortunately, that is not the world we inhabit. On the contrary, ours is a world in which too many corporate defined benefit plans have terminated without enough assets to cover the liabilities. Responsible companies and perhaps even taxpayers are on the hook for picking up the tab, and most importantly, too many workers and retirees have their expectations of a financially secure retirement shattered.

Mr. Chairman, this is not about the PBGC. The agency is only a conduit. This is about retirement security. Consider the Bethlehem Steel worker who started at the mill in January of 1972 at age 19 and retired in April of 2002 at age 50 with just over 30 years of service. Every month, this worker was receiving a pension check from Bethlehem Steel in the full amount he had earned, $3,641. But when the plan terminated in a woefully underfunded State, statutory limits on PBGC's insurance coverage reduced his monthly benefit to $1,192, a 67 percent reduction.

This is the human toll exacted by the failure of companies to adequately fund the pension promises they have made to their workers. Moreover, PBGC's record deficit raises the specter that workers in failed pension plans will lose twice, once when their company failed to live up to its promises, and a second time when the government cannot fulfill its guarantee.

At a recent meeting, workers and retirees in a terminated pension plan were told that the PBGC has sufficient assets to pay benefits for perhaps as long as 20 years. That was small comfort to one 45-year-old participant who noted with dismay that PBGC could run out of money just as he was preparing to retire.

The administration believes that the pension promises companies have made to their workers and retirees must be kept. That is why the administration's proposed comprehensive reforms are designed to strengthen the financial health of the defined benefit system. Underfunding in the pension system must be corrected now to protect worker benefits and ensure that taxpayers are not put at risk of being called upon to pay for broken promises.

Mr. Chairman, we recognize that the defined benefit system is a voluntary one and we have made every effort to balance the interest of all the system's stakeholders. Not surprisingly, some in the pension community have complained that we are being too tough on them, that the reforms will cause them to exit the system.

Let us be clear. Under the status quo, we have seen an exodus from defined benefit plans over the past 20 years. Under the status quo, we have seen a growing number of plans that are substantially underfunded terminate. Maintaining the status quo is not going to save the system.

We believe that the proposed reforms are not only necessary to address the systemic flaws that have led us to this hearing, but that they are also fair, responsible, and measured.

While some issues raised by sponsors and other stakeholders warrant further consideration, many of the arguments are without merit. I would like to briefly touch upon a few of them.

For example, we are told the proposal would increase volatility and make contributions more unpredictable. This simply isn't true. The risk and volatility associated with defined benefit plans is a function of the investment and business decisions made by plan sponsors. Our objective is only to ensure that this risk is transparent to all stakeholders. Current smoothing rules simply masks the risks and volatility. Moreover, companies have the means under current law to manage these risks in accordance with their own risk tolerances and the administration proposal provides additional tools to control volatility, including 7-year amortization of pension deficits and the enhanced ability to pre-fund benefits in good economic times.

We are told that the corporate community cannot tolerate the use of a corporate bond yield curve to discount pension liabilities, even though yield curves are used regularly to value other financial instruments, such as mortgages and certificates of deposit. Discounting future benefit cash flows using rates from a spot yield curve is the most accurate way to measure plans' liability and does not change the obligations that make up the plan liabilities in any way.

We are told that corporate credit ratings should not be used to determine pension funding or PBGC premiums, but it is both reasonable and fair to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations. Even so, the administration provides a 5-year phase-in to the higher at-risk funding target for any plan whose sponsor becomes financially weak.

We are told that companies will have no incentive to make extra pension contributions if they can't take advantage of credit balances, yet it is the credit balance feature of current law that allowed companies like Bethlehem Steel, U.S. Airways, and United Airlines, PBGC's largest claims, to avoid making contributions to their plans for several years prior to termination. This is true, notwithstanding the fact that they were already substantially underfunded and the amount of underfunding grew significantly during the run-up to termination.

We believe sponsors would have ample incentive under the administration's proposal to make more than the minimum required contributions for three reasons. First, they would generate a larger tax deduction. Second, they would shorten the amortization period. And third, their risk-based premiums would be lower.

Finally, Mr. Chairman, we are told that the proposal on PBGC premiums would put an inappropriate burden on employers with well-funded plans and would result in volatility and an added burden on financially-stressed companies. It is understandable that plan sponsors would rather not pay higher premiums or subsidize underfunded plans of financially-weak sponsors. The ultimate issue is who pays for past and future claims.

As I noted, the administration believes that companies that make the promises to their workers should pay for them, which is why we have put so much emphasis on strengthening the funding rules. But changes to premiums are still necessary to compensate for the losses that have and inevitably will occur.

Mr. Chairman, the administration's pension reform proposal is necessary to improve the financial health of defined benefit pension plans and strengthen the Federal pension insurance program that stands behind them. We look forward to working with you and the committee to enact pension reform legislation, and I would be pleased to answer any of your questions.

Senator DEWINE. Mr. Belt, thank you very much.

[The prepared statement of Mr. Belt follows:]

PREPARED STATEMENT OF BRADLEY D. BELT

SUMMARY

In an ideal world, pension promises would be fully funded and retirees would receive the full benefits they have earned. But reality is that companies fail to adequately fund plans and workers too often are robbed of a secure retirement when an underfunded pension plan terminates. Structural flaws in the system that have allowed underfunding must be corrected now to protect the 35 million workers and retirees in the single-employer system and to ensure that the burden of unfunded pensions does not eventually have to be shifted to taxpayers.

The administration has proposed reforms to correct these flaws. We believe the proposals are fair and responsible. This testimony addresses objections that we feel are not warranted:

(1) Assertion: Contributions would be more volatile and unpredictable if current law smoothing mechanisms were eliminated. In fact, current law smoothing rules mask true liability but do not eliminate volatility. Employers decide the extent to which they will manage that risk. The proposal increases transparency by measuring liability more accurately. It also provides additional tools to manage volatility, including 7-year amortization of pension deficits and an enhanced ability to pre-fund benefits in good economic times.

(2) Assertion: Valuing pension liabilities using a yield curve will be too difficult and expensive. Yield curves are used regularly to value other financial instruments such as mortgages and certificates of deposit. Discounting future benefit cash flows using rates from a spot yield curve is the most accurate way to measure a plan's liability and does not change the obligations that make up plan liabilities in any way.

(3) Assertion: Corporate credit ratings should not be used to determine pension funding or PBGC premiums. It is both reasonable and fair to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations. Even so, the administration provides a 5-year phase-in to the higher "at-risk" funding target for any plan whose sponsor becomes financially weak.

(4) Assertion: Companies will have no incentive to make extra pension contributions if they can't take advantage of current law credit balances. Credit balances allowed Bethlehem Steel, US Airways, and United (PBGC's largest claims) to avoid making contributions for several years prior to termination, despite substantial underfunding in their plans. Our proposal gives important incentives to contribute more than the minimum: a larger tax deduction and lower risk-based premiums.

(5) Assertion: The proposed PBGC premium structure would put an inappropriate burden on employers with well-funded plans and would result in volatility and an added burden on financially stressed companies. It is understandable that plan sponsors would rather not pay higher premiums or subsidize underfunded plans of financially weak sponsors. The ultimate issue is who pays for past and future claims.

Mr. Chairman, Ranking Member Mikulski, and members of the committee, good morning. I want to commend you for holding this timely and important hearing. I appreciate the opportunity to discuss the financial challenges facing the defined benefit pension system and the pension insurance program, and the administration's proposals for meeting these challenges.

Before I outline some of the reasons why fundamental and comprehensive pension reform is so urgently needed, I think it would be helpful to step back, take a look at the big picture, and ask three questions:

- Where are we?

- How did we get here? and
- What needs to be done?

Where Are We?

A secure retirement depends on all three legs of the so-called retirement stool—Social Security, personal savings, and private pension plans. As you know, the President has made retirement security a top national priority, and he is committed to strengthening each leg of the stool. I would like to focus my comments on one vitally important leg: defined benefit pension plans.

Private-sector defined benefit plans have been and are intended to be a source of stable retirement income for more than 44 million American workers and retirees. Unfortunately, as I discuss more fully below, the defined benefit system is under severe stress—the number of defined benefit plans has fallen precipitously over the past 2 decades, the percentage of the workforce covered by such plans has dropped by half, and, in many cases, benefits are being frozen or the plans are being closed to new participants.

More ominously, there have been a growing number of instances in which plans have been terminated by their sponsors with assets far insufficient to pay the promised benefits. This results in lost benefits for a number of participants in those plans, threatens the long term financial solvency of the insurance program, requires sponsors that have acted responsibly to pay higher premiums, and potentially could lead to a call for a rescue of the program with taxpayer funds.

I would emphasize that this has occurred under the current statutory and regulatory framework. In order to stop the hemorrhaging in the system, to put the insurance program on a sound financial footing, and to best protect the benefits of millions of workers and retirees, the administration believes that comprehensive pension reform is critically needed. If we do nothing or merely tinker at the margins the inevitable outcome will be a continued erosion of this important retirement security leg and continued large losses for participants, premium payers and potentially taxpayers.

State of the Defined Benefit System

Traditional defined benefit pension plans, based on years of service and either final salary or a flat-dollar benefit formula, provide 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.

Senator DEWINE. The administration's proposals would require some employers to make much larger pension contributions starting right away. How much modeling has the administration done to determine how many companies would not be able to meet those sudden increases in cash flow demand, and how certain are you that we will not see more bankruptcies as a direct result of this proposal or that you are not turning some of those probable problems into really definite problems for the PBGC?

Mr. BELT. A very good question, Mr. Chairman. Let me first note that we have to compare the administration's proposal relative to current law. Current law has more onerous funding requirements than does the President's proposal. Under current law, many companies are sucked into the DRC requirements, deficit reduction contribution requirements, and the amortization period could be as short as 3 years under current law. It is under current law that the airlines and others are having a very difficult time meeting their funding obligations.

The administration proposal provides a much more measured time frame within which to fund the pension plan fully, a 7-year time frame. In addition, we provide additional incentives to fund up, if the company has the ability to do so, relative to current law.

I would also note that we make no changes to current law relative to the ability to obtain a waiver if there is a temporary business hardship confronting the company that they can apply to the IRS, and the IRS consults with the PBGC and they may have the

ability to obtain some funding relief. So we believe that there are ample mechanisms available both under current law as well as the President's proposal to address those issues. But the bottom line is, I do not believe that the administration proposal relative to current law is any more likely to force anybody into bankruptcy.

Senator DEWINE. We have seen press reports about abuses at the credit rating agencies, yet the administration has proposed giving those entities enormous power, including the power to stop benefit payment options and accruals that have been collectively bargained and the power to undercut an individual's retirement planning. How do you respond to criticism that the government would be giving this power to nameless analysts who are basically not subject to significant oversight?

Mr. BELT. Mr. Chairman, I would simply note that it is not really the government that gives them this power. These agencies have this power under current law. Rightly or wrongly, that is the way the current market structure works. These companies really set the cost of capital for companies that they cover each and every day in the marketplace. It is a combination of credit ratings, credit spreads on their publicly traded debt, as well as financial instruments like the credit default swaps market.

In addition, there are numerous other instances within government where there are credit risk elements used to price premiums or to apply to underwriting requirements, for example. As you know, the SEC recognizes the credit rating agencies under SEC proposals. In addition, the banking regulators use a credit risk element that pertains to the premiums as well as the underwriting requirements or capital standards that banks must live up to.

Senator DEWINE. Senator Mikulski?

Senator MIKULSKI. Thank you very much, Mr. Chairman, and I note Senator Enzi is here. I was just complimentary to you, Senator, about encouraging us to look at the pension issue. It is like a big convergence in the Senate today. The Finance Committee is holding a hearing on the solvency of Social Security and we on the PBGC, and I believe that there are strong similarities.

Tell me, what is the solvency of the PBGC? In other words, where are you and how long will you be okay, and are you okay?

Mr. BELT. As we reported, at the end of the last fiscal year, we had a deficit of $23 billion. We also have substantial exposure to potential future losses. Those numbers have grown substantially, as well. The overall underfunding in the system has grown, and we estimate at the end of last year it was more than $450 billion. In addition, we have nearly $100 billion of exposure to plans that are sponsored by companies which are at a higher risk of default or terminating the pension plans, junk-rated sponsors.

So there is a substantial amount of losses that have already been incurred and a substantial amount of future losses that we could reasonably expect, particularly if there are no changes to the current regulatory and funding rules.

There has been the question raised as to, well, there is no problem because the PBGC is sitting on $40 billion of assets, and indeed, under our current business model, we have sufficient liquidity to pay benefits for a number of years yet. The problem is that the hole gets deeper each and every day.

If, for example, I take over United Airlines' pension plans——

Senator MIKULSKI. Could I jump in, because I have only a few minutes. So what you are saying is, right now, you have $23 billion in debt——

Mr. BELT. Of unfunded obligations——

Senator MIKULSKI. [continuing]. Unfunded obligations, and this is why I believe Senator Enzi told us to have this hearing You know, the American worker who has ever had to turn to PBGC sees this almost as the FDIC of pensions, and if I might say too, dear colleagues and so on, I am worried that this could be like another savings and loan crisis. It all looked okay, and then 1 day, all of a sudden, America had this tremendous unfunded liability because we didn't stand sentry in the way we needed to. They are not identical, but that is the way the worker thinks and I know my colleague from Georgia is just shaking his head.

So number one, reform is needed. You could be hit by a tsunami if all of these companies go under fast. Am I correct?

Mr. BELT. We have certainly seen that occur in the steel industry. We have seen that now to some extent in the airline industry.

Senator MIKULSKI. Right.

Mr. BELT. We also have exposure to other industry sectors.

Senator MIKULSKI. That is exactly right. So my question then is, what would be, in terms of must do, should do, would like to do reforms, and when, to really move this to solvency and not leave the American people with an incredible unfunded liability and, therefore, devastating the lives that depend on it? It is a $100 million obligation. Just put the people behind those numbers and it is really scary.

Mr. BELT. That is an excellent question, Senator Mikulski. Clearly, the most important thing is to make sure the plans are fully funded. We need to strengthen the funding rules. We have funding rules in place now, but they demonstrably have failed. We would not have instances of companies terminating pension plans at only 30, 40, 50 percent funding levels, with billions of dollars of underfunded liability, if the funding rules worked.

There are inevitably going to be business cycles. Companies, for a variety of reasons, are going to fail. We can't change that. What we need to change is that if they are sponsoring a pension plan when that company fails, the pension plan is fully funded so the workers and other premium payers and the taxpayers are not put at risk.

Senator MIKULSKI. Well, let me raise a question, because I am so glad you talked about Bethlehem Steel, and I have another question related to them that I will submit in writing.

But when I met with Bethlehem Steel executives before the crisis and then the consolidation, etc., those executives assured me that the best steel pension plan was funded. Now, this was in the 1990s, and these were honorable men, so I don't dispute what they said. They said, oh, thank God, the market is doing well. Our pension is funded. So I breathed a sigh of relief that at least while we worked on other things, like dumping and predatory practices, etc, the pension was funded.

Then, bang, Bethlehem Steel says goodbye, a melancholy goodbye, you know, and then the pension wasn't funded. Thank God for

PBGC. But as you have indicated, their pension was reduced. Thirty years, 35 years of black smoke, bad backs, varicose veins, working in rough, tough work, and what the hell did it mean? They are feeling that very keenly.

So my question to you is surrounding this—and I see my time is up—is they tell workers one thing, then it doesn't work out. I am into the prevention so we don't have to intervene. Is there a different way we can do this?

Mr. BELT. Certainly one of the issues there which caught everybody by surprise, although the PBGC had the relevant information, we are not able to disclose it, is that they were able to report on a current liability basis, which bears very little relationship to economic reality, that they were fully funded in the years leading up to the termination, and I have a slide in my written testimony that demonstrates that, 91, 99, 80-plus-percent funded, whereas, in fact, on a termination basis, they were only 45 percent funded.

Senator MIKULSKI. See, that is what they were telling me.

Mr. BELT. And the issue is obviously we need better liability measures, which is one of the core elements of the administration's proposal, so that, in fact, everybody has an understanding of what it means to be fully funded or not fully funded. Right now, you have current liability, you have termination liability, you have FAS liability, you have the full funding limitation. Nobody knows what it means when somebody says, oh, we are fully funded.

Senator MIKULSKI. Well, thank you. Mr. Chairman, you have been very gracious, but I think we see how complicated and technical this is. The other thing that happened was—and I am going to submit this question in writing, with your indulgence of an extra minute—the guys got their checks and the women who also worked there, and then they were told that your agency made an overpayment and then they had to give back thousands of dollars. It was a mess. It is too complicated to go into here, sir.

I would like to submit a letter to you giving the background and two things. One, can we get any of their money back for them? And number two, how could we prevent—because they were hit by a double-whammy. They lost their pension. They got money from you, and then they were told they got too much. But let me submit that in writing and go on to other questions of my colleagues.

Mr. BELT. I am aware of that recoupment issue and we would be delighted to address that more fully.

Senator MIKULSKI. Thank you. I really look forward to working with you, sir.

Senator DEWINE. Thank you, Senator.

Senator Isakson?

Senator ISAKSON. Thank you, Mr. Chairman.

Director Belt, in the answer to the question preceding the last exchange with the Senator from Maryland, I think I got you right. You were making a comment where the goal would be to see to it that if companies ran into financial difficulties and bankruptcy became inevitable, that the pension fund would be funded so that they could meet their obligations to their retirees. Was that a correct statement of the goal?

Mr. BELT. That is correct.

Senator ISAKSON. Given the current climate that we are in, where we have had a stock market period from late 1999 through 2002 which caused a lot of problems in the actuarial underpinnings of these pension funds and other things that have happened, in accomplishing that goal, we do go back to running the risk, however, of which comes first, the bankruptcy or the fully funding the pension fund, is that not correct?

Mr. BELT. That is certainly an issue under current law. We would believe it would be less of an issue, Senator Isakson, under the administration's proposal since we provide a smoother funding path than does current law, which has—in which the deficit reduction contribution rules are implicated.

Senator ISAKSON. That is a longer amortization period, correct?

Mr. BELT. It is as short as 3 years under current law.

Senator ISAKSON. Correct. There is a third component. There are a number of components to pension plans, but one of those components are the benefits that have been promised, defined benefits that have been promised to the retiree, but it is possible for those retirees to amend their own benefits as a part of a plan reorganization, is it not?

Mr. BELT. They can amend future benefits. There are rules in place which do not allow them to give up, in a sense, accrued benefits.

Senator ISAKSON. Yes. There is a constitutional right of contract, I think, for the ones that are earned to date, but future ones can be amended, is that not correct? In that case, that also can be a part of the solvency of a pension plan, couldn't it, a combination of a change in the amortization, i.e., in the President's proposal or another proposal, plus beneficiaries amending their future benefits that would otherwise be calculated in the actuarial figures, am I correct there?

Mr. BELT. Certainly those are things that can be done under current law, and if it is covered by a collective bargaining agreement, that would be subject to any strictures in the CBA.

Senator ISAKSON. This is probably not a fair question to ask you in your position, but it seems to me in all cases that if the company and the employees can solve the problem, we are always better than the Pension Benefit Guaranty Corporation having to take it over, would that not be correct?

Mr. BELT. Senator, certainly I think everybody's interest is best served if companies are able to honor the pension promises they made to their workers, they maintain those plans. Everyone is hurt when the PBGC has to step in and take over an underfunded pension plan. By the same token, I think we would all agree that we need to make sure that any actions we take do not simply result in further losses down the line or exacerbate the moral hazard that already exists in the system.

Senator ISAKSON. That is a very responsible answer and I appreciate that answer.

The Senator from Maryland, she was thinking exactly what I have been saying. I was in the residential real estate business during the days of the Office of Thrift Supervision and the savings and loan bailout, and although the guarantees made by the FSLIC and the problems were different, in quotes, than the pension issue,

there are many, many similarities. Leading up to the failure of the savings and loan associations were a series of well-intended but poorly thought out government decisions that affected the S&L industry and put it in a precarious situation. I think there is an analogy there with where we are with pensions today.

Mr. BELT. I agree wholeheartedly.

Senator ISAKSON. We need to be very careful that for the best of intentions, we don't make decisions that have the worst of ramifications for the Pension Benefit Guaranty Corporation and for those future retirees, as well. But I think it is the best, clearest example of what could happen if we don't act responsibly and in such a way to maximize the benefit of these pension funds to survive in a joint venture between those future beneficiaries and current beneficiaries, the company hopefully still staying in business and having you as an absolute worst case fallback, both from a standpoint of the beneficiary as well as the American taxpayer.

I see my time is up, so I will end with that comment, Mr. Chairman.

Senator DEWINE. Senator Enzi?

The CHAIRMAN. Thank you, Mr. Chairman. I appreciate your holding this hearing. I would ask that my full statement be a part of the record.

Senator DEWINE. It will be made a part of the record.

[The prepared statement of the Senator Enzi follows:]

PREPARED STATEMENT OF SENATOR ENZI

On March 15, the HELP and Finance Committees held a joint forum to look into the long-term future of private sector retirement security plans. A general consensus was reached by our 17 participants that our Nation's private defined benefit plans have been extremely beneficial, and in some cases essential, for many workers' retirement needs.

I appreciate Chairman DeWine holding today's hearing to explore the mechanics of our defined benefit system and the administration's proposal to increase the schedule of premiums that pension plans pay to the Pension Benefit Guaranty Corporation (PBGC).

While the administration has proposed setting new premiums, it should be done in the broader context of pension reform. However, we must be able to determine the correct way to value assets and liabilities of the plans before we can get to the question of how to set the premiums.

Our private sector defined benefit system is a voluntary system—a system that everyone agrees we should preserve. A taxpayer bailout is not an option. This committee needs to find out that if costs are raised too drastically and too quickly whether individual companies and their employees may not be able to bear the additional costs. My fear is that the administration's proposal will lead to the collapse of the overall defined benefit system.

We do not want to destroy what is left of the defined benefit pension plan system in the United States by setting up a premium schedule that can be otherwise viewed as a confiscatory tax system on plan sponsors.

Restoring the PBGC to solvency and removing it from the GAO "Watch List" are important. However, they are not the only priorities, and some may say that they are not the highest priorities. Getting money into employees' pension plans and having workers and companies negotiate within their means are certainly more important than simply increasing pension costs on pension plan sponsors. It is irresponsible of companies that do otherwise. Overall reform will be that much more difficult to achieve if companies are strong-armed into a short-term fix of the system.

Clearly, these issues are all interrelated and that is why comprehensive pension legislation is necessary to stabilize the private sector defined benefit system.

Recently, many household-name companies have announced that they are freezing their defined benefit plans: Sears, Ford, Motorola, GE, Xerox, and Rockwell-Collins, and the list goes on and on. These are not bankrupt companies. They are the not the "bad actors" that the administration has been criticizing. Yes, they have had to look at their business plans and budgets. CFOs and CEOs must evaluate how much volatility and liability they are willing to take onto their balance sheets and their earnings per share in order to keep their defined benefit plans active.

Certainly we need to shore up the finances of the PBGC. But we must ask, are we making the defined benefit system better, or do we hasten its demise?

With regard to the defined benefit pension plan system, Congress needs to take the Hippocratic oath: First do no harm.

I look forward to the testimony of Mr. Belt and the other panel of outstanding witnesses to help us understand these very difficult but timely issues.

Thank you Mr. Chairman.

The CHAIRMAN. This is being done at a particularly critical time because the Budget Committee is trying to reach some agreement at the moment on what language will be in there that you will have to deal with in order to solve this vast problem. I have a lot of confidence in you and Senator Mikulski to be able to get that done.

Senator MIKULSKI. OK.

[Laughter.]

The CHAIRMAN. I will be right there helping.

Senator DEWINE. We have confidence you will help get the right figure, too, Mr. Chairman.

[Laughter.]

The CHAIRMAN. We are working on that. We are having some difficulty.

Senator DEWINE. I understand.

The CHAIRMAN. Mr. Belt, the administration's proposal doesn't expressly rate a pension plan on its asset allocation or mandate a specific investment strategy. In hearings before other committees, the administration witnesses have expressed a preference for plans to invest in bonds in order to bear the market risk themselves rather than engaging in the moral hazard of rolling the dice on stock. But while the administration plan doesn't demand a shift to bonds, many believe that is the logical and desired result. The elimination of the 4-year weighted average is one such change.

Isn't such insistence on a nonsmoothed interest rate the same as telling plans to invest in bonds? What would happen to the pension plan's rate of return if it completely insulated the PBGC from losses by investing 100 percent in bonds?

Mr. BELT. That is an excellent question, Senator Enzi. I want to make one point of clarification. I have certainly never said, and I don't believe any administration official has ever indicated, nor is it part of the administration's proposal, that companies should shift into bonds. Those are business decisions best made by the company, by the CEO and CFO and CIO as to how they allocate assets in the pension plan.

What I think we are trying to say is that there are risks embedded in those decisions. Let us just make sure that those risks are transparent and understood by all the stakeholders.

I know there have been some who have said, well, this is going to cause a massive shift into equities if all of a sudden this risk becomes transparent to shareholders, to participants, and others. I don't believe personally that that will be the case, and it is very interesting. I know we have a witness that will talk about the UK experience on the second panel as to what has transpired there.

The same argument was made in the UK with respect to the adoption of FRS 17, which was going to require mark-to-market of assets and liabilities, as well. But has that been the experience? No. As of the end of 2004, the asset allocation to equities by UK pension plans, according to Russell Mellon, was just over 65 percent. It was just over 68 percent the year before, and that 3 percent shift was not all into equities. It was into hedge funds. There has not been a massive shift.

The CHAIRMAN. So you are saying that the elimination of the 4-year weighted average isn't insistence on a nonsmoothed interest rate?

Mr. BELT. It is——

The CHAIRMAN. We should tell people to invest in bonds?

Mr. BELT. It would be—we would certainly—we definitely believe that there should not be smoothing, that that simply masks risk and volatility. We do not believe that that would necessarily lead to a shift in asset allocations. If companies—we believe companies should be prudently managing both the assets and liabilities. Heretofore, they have been able to take substantial risk, but it is the company that bears the up-side of that risk. It is the pension insurance program that bears the consequences of a mis-bet.

The CHAIRMAN. To clarify my original question, I mote that in questions and answers in front of the Senate Finance Committee, the Tax Benefits Council at Treasury told the committee that if sponsors don't want to suffer through volatility, they should invest in bonds.

Mr. BELT. There are numerous mechanisms under both current law as well as the administration's proposal to take risk off the table should they choose to do so. If they want to volitionally take on that additional risk, as long as that is transparent to the shareholders, to participants, and everyone, all the other stakeholders, that is a business decision we believe should be made by the company.

The CHAIRMAN. In a study by the Center on Federal Financial Institutions, Doug Elliott expresses the concern of many that the premium proposal in the President's budget relies so heavily on variable premiums collected on underfunding that it is likely to drive underfunding down to a level where no reasonable premium rate could bring in the projected dollar amount. How do you respond to that criticism?

Mr. BELT. It is very difficult to model behavioral changes. Our past experience is that under current law, most companies tend to simply contribute the minimum, not the maximum allowed by law, notwithstanding some assertions to the contrary. But I guess in some respects, that would be a nice problem to have. That is, everybody becomes fully funded so we don't have to charge higher premiums. That is the whole notion of an insurance system. If you don't have losses, you can keep premiums down as low as possible. That is the reason why we put so much emphasis on the funding rules.

The CHAIRMAN. My time has expired.

Senator DEWINE. Mr. Belt, thank you very much. We look forward to working with you on the subcommittee and appreciate your time very much.

Mr. BELT. Thank you all.

Senator DEWINE. Thank you.

Let me invite our second panel to come, and as you all come up, I will begin to introduce the second panel.

On the second panel, we will hear from Ian MacFarlane of Medley Global Advisors. Mr. MacFarlane will tell us about the experience in the United Kingdom with pension reform, pension insurance agencies, and the impact recent changes there have had on the viability of the pension schemes, as they call them.

Next, we will hear from Sallie Bailey, Vice President for Finance of the Timken Company of Canton, OH. She will give us observations regarding the administration's proposals to increase the PBGC premiums and funding standards from the plan sponsors' perspective.

The last two witnesses will be Ron Gebhardtsbauer, former Chief Actuary of the PBGC and now the Senior Pension Fellow at the American Academy of Actuaries, and finally, Mr. Alan Reuther, Legislative Director of the United Auto Workers.

We welcome all of you here and appreciate very much all of you being here.

Mr. MacFarlane, we will start with you. Thank you very much.

STATEMENTS OF IAN MacFARLANE, MARKET STRATEGIST, MEDLEY GLOBAL ADVISORS, NEW YORK, NY; SALLIE BALLANTINE BAILEY, SENIOR VICE PRESIDENT-FINANCE AND CONTROLLER, THE TIMKEN COMPANY, CANTON, OH; RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES, WASHINGTON, DC; AND ALAN REUTHER, LEGISLATIVE DIRECTOR, UNITED AUTO WORKERS, WASHINGTON, DC

Mr. MACFARLANE. Thank you very much, Mr. Chairman, ladies and gentlemen.

There was an actuarial estimate of the deficit of defined benefit schemes for the top 100 companies which was carried out in the middle of 2004. That showed that the deficit on those defined benefit schemes amounted to about 42 billion pounds Sterling. Now, that might not have much relevance to you in the United States, but that constitutes about 9 months of profits the previous year of those 100 companies. That is pre-tax profits.

I think there is a lot of similarity between the problems which the United Kingdom has gone through in the years since the new millennium and what is occurring here in the United States. Both countries are grappling with aging populations, increasing longevity, and mature pension schemes which are creating a demand for increased cash flow. The pension debate promises to be at the center of political debate in both countries for many years.

Given the vastness of the topic, I shall limit my remarks here to the UK experience with FRS accounting standards and its relevance in particular to the proposed introduction of a contemporaneous interest rate for the discounting mechanism in the United States.

The implications of the UK experience with FRS 17 for the United States, I think, are unambiguous. Increased transparency is to be welcomed. Demographic trends and lower expected investment returns cry out for it. But volatility in company accounts could well be the unintended side effect, threatening dividend payments and employment. In this case, the objective of ensuring retirees' financial security is jeopardized by the threat of them not getting to retirement within the scheme.

According to Adair Turner, the Chairman of the Pension Commission, between 60 and 70 percent of defined benefit schemes are now closed to new entrants in the United Kingdom. The cost of pension provisions have become too much for the employer in a cost-conscious environment. While FRS 17 was not the primary cause, at a minimum, it added additional administrative burdens, and at worst, created enough uncertainties to prompt asset classes to switch out of equities into fixed-income, and there is one particular example, Boots, where they actually moved 100 percent into fixed-income to try and take the volatility off their balance sheet. And their experience subsequent to that has actually been that they have run surpluses at a time when a lot of the other companies have actually run—schemes have run deficits.

What is FRS 17? FRS 17 is an accounting standard which was introduced in the UK to improve the transparency of future pension costs measured in terms of a surplus or deficit. They key point is its primary aim, to provide shareholders with a snapshot, and the emphasis is on a snapshot, of future costs at a particular point in time. This means that calculated pension costs can sometimes change dramatically from year to year.

I started by quoting the fact that in the middle of 2004, the estimated deficit was about 42 billion. The estimated deficit the previous year was about 55 billion, so about a 13 billion pound shift, which is quite dramatic, and that was the result of improved investment performance, as well moving the opposite direction in interest rates, which actually raised the actual accounting liability.

Concerns over FRS 17 have, therefore, focused primarily on the volatility of imparts to company accounts, owing to the capture of market noise and the sensitivity of actuarial events to even small changes in assumptions. Again, if we take that point in mid-2004, if you were to have raised the interest rate on the corporate bonds by 1.5 percent, that would have eliminated that deficit. By the same token, and just extending that analysis a little bit further, if Britain was to actually go into the European exchange rate mechanism, the net result—or to join the Euro—the net impact of that would be to add about 20 billion pounds onto that 42 billion pound figure, or to actually increase the deficit by 50 percent. Likewise, if you were to actually change the actuarial assumptions because people are living longer, that would add another 20 billion.

What I am trying to drive at here is these deficits and surpluses can swing around very dramatically in response to just very, very small changes in assumptions, and this speaks to the weakness of a snapshot approach, I think.

The background to the introduction of FRS 17 is important in understanding how problems thrown up by FRS 17 emerged. The accounting standard did not initiate the trend to higher pension costs, but merely accentuated them. It was conceived at a time when equity returns peaked, just after Advanced Corporation Tax, which allowed pension funds to claim a tax credit on dividends, had been abolished, and at a time when many companies had been taking a contribution holiday. Through the 1990s, a lot of companies were actually running surpluses. The shift from surplus to deficit was very dramatic and happened very quickly and, therefore, went contributing. FRS 17 helped bring home to them the costs of ending that holiday.

Now also peculiar facts in the UK which also—a high ratio of equities in the total. I think the point I want to drive at here is essentially that FRS 17 has actually served to exacerbate the trends which were already evident.

It therefore seems to me that a snapshot approach in increasing volatility also potentially works in reverse in terms of the efficient allocation of capital, which increased transparency is supposed to bring about. Defined benefit schemes tend to be more prevalent in the old industries who are not growth companies but more value-oriented dividend payers, and I think that is key. It would be a shame if noise disrupted the painful transition many of these companies in the United States are currently facing from developed market competition, and I think that is the evidence, or the lesson which the United Kingdom provides for the United States as it has its pension debate.

Thank you very much.

[The prepared statement of Mr. MacFarlane follows:]

PREPARED STATEMENT OF IAN P. MACFARLANE

My name is Ian MacFarlane, a Director at Medley Global Advisors in New York, a leading firm of macro political advisors and I am appearing here as someone with experience in the provision of pension fund products within the United Kingdom, and elsewhere in the globe, over the last 25 years.

As the United States debates the issue of pension fund reform, the UK experience with the pension accounting standard FRS 17 between 2001 and 2004, and a new pension bill (The Pensions Bill 2004), are I think very relevant to the United States. **This is particularly so at a time when both countries are grappling with**

aging populations, increasing longevity and mature pension schemes. The pension debate promises to be at the center of political debate in both countries for many years. Given the vastness of the topic I shall limit my remarks here to the UK experience with the FRS 17 accounting standard and its relevance, in particular, to the proposed introduction of a contemporaneous interest rate for the discounting mechanism in the United States.

The implications of the UK experience with FRS 17 for the United States are I think unambiguous. Increased transparency is to be welcomed. Demographic trends and lower expected investment returns cry out for it. **But volatility in company accounts could well be the unintended side effect, threatening dividend payments and employment. In this case the objective of ensuring retirees financial security is jeopardized by the threat of them not getting to retirement within the scheme.**

I say this against the backdrop of what can only be described as a crisis within the UK pension funds industry. FRS 17 was not the cause of the crisis but has certainty not helped. **According to Adair Turner, the Chairman of the Pension Commission, between 60 percent and 70 percent of defined benefit schemes are now closed to new entrants.** The costs of pension provision have become too much for the employer, in a cost conscious environment. While FRS 17 was not the primary cause, at the minimum it added additional administrative burdens and at worst created enough uncertainty to prompt asset class switches out of equities into fixed income to obviate the uncertainties on company balance sheets. This has not always been consistent with maximizing investment returns for any given level of risk. **All of this is occurring at a time when as the Pension Commission concluded "people must save more or work longer."**

Well they are not saving more. Since 1997 the rate of growth of consumer spending has exceeded GDP growth by 6.5 percent points. If ever there was a time when defined schemes were needed it is now. This is a pattern, at least in respect of consumption, eerily reflected in the United States.

FRS 17 is an accounting standard introduced in the UK to improve the transparency of future pension costs measured in terms of a surplus or deficit. Its primary aim is to provide shareholders with a snapshot of future costs at a particular point in time. This means that calculated pension costs can change sometimes dramatically from year to year. Under the previous accounting standard of SSAP24, which was predicated on the assumption that pensions were a long-term commitment, the principles and guidelines were left for company directors to interpret. Effectively the impact was to produce a stable pension expense from year to year. Initially the provisions of FRS 17 could be merely attached as a note to company accounts, under transitional arrangements, but as from 1 January this year full implementation has made it mandatory to include them in the reported figures for non listed companies. Listed companies now have to switch to IAS 19 (an option non-listed companies can also choose) which will be very similar to FRS 17 after a technical amendment. For clarity I will limit my remarks to the historic experience with FRS 17.

Concerns over FRS 17 have focused primarily around the volatility it imparts to company accounts, owing to the capture of market noise and the sensitivity of actuarial estimates to even small changes in assumptions. What could be viewed as a healthy situation 1 year could be construed as a parlous situation the following year. For example, an increase in the longevity assumptions of employees or even the discount rate could lead to a shift to deficit or a sharp increase in the deficit. **Because the approach is snapshot, this shortfall could then threaten the ability of a company to pay a dividend, although there had been no deterioration in the financial position of the company from the previous year. The share price would be hit and the cost of capital would effectively rise, reducing economic growth, if repeated across the market.**

The background to the introduction of FRS 17 is important in understanding how problems thrown up by FRS 17 emerged. **The accounting standard did not initiate the trend to higher pension costs, but merely accentuated them.** It was conceived at a time when equity returns peaked (2001), just after Advanced Corporation Tax which allowed pension funds to claim a tax credit on dividends had been abolished, and at a time when many companies had been taking a contribution holiday. FRS 17 helped bring home to them the costs of ending the holiday.

The issues were further complicated by the fact that the benchmark for the UK pension industry was the default of the median holdings of various assets across all funds, rather than related to the liability structure of the individual fund. As equity returns declined post 2000 many funds found themselves with deficits, or in some instances an asset mix inappropriate to the cash flow demands as the scheme aged,

both related to over exposure to equities. **The median holding of equities in some asset mixes frequently rose over 80 percent.** No effective re-balancing of the asset mix portfolios was under taken over the previous 30 years, and as equity returns exceeded bond returns the ratio of equities in the asset mix drifted up. Unsurprisingly individual schemes have recently begun to shift to client specific benchmarks.

FRS 17 was therefore always going to expose deficits in the funding requirements of individual pension plans. To that end it has to be argued that in principle the accounting standard was an important step forward relative to the subjective approach of the SSAP24 guidelines. The issue is the volatility that the snapshot approach imparts to company Profit and Loss Accounts. **This strikes at the heart of the proposal to use a contemporaneous discount rate rather than the 4-year average here in the United States. Such an approach would merely introduce noise into the equation.**

And despite all the greater transparency and rigor and efforts to move away from the subjectivity of SSAP24 there have still been quite on occasion large disparities in the numbers used for key assumptions. Variations in the discount rate used, which should be among the least controversial assumption, illustrate this point well.

Theoretically the discount rate across funds which should coalesce around the yield on AA corporate bonds with a maturity of greater than 15 years. But for 2003 a survey by actuaries Barnett Waddingham found that the discount rate used by 42 FTSE 100 companies varied between 5.25 percent and 5.6 percent compared with 5.2 percent and 6 percent the previous year. To the extent that the assumptions have to be clearly stated, however, a comparison across funds can be made.

The use of the corporate bond rather than a matching yield under the previous arrangements could also be argued to increase the accounting liability, via increasing the demand for corporate bonds and lowering interest rates. The growth in the UK corporate bond market over the last 5 years is grounds for suspicion that this is indeed the case. **But, it could also equally be argued that the cash flow demands of mature pension funds, notwithstanding the decision by Boots to switch 100 percent into fixed income, would have resulted in an increased appetite in their own right.**

There has also been a belief that FRS 17 has meant the effective end of defined benefit schemes (final salary schemes) for new joiners for a company where one exists (i.e. the schemes close for new entrants). Again although the increasing shift to new employees joining defined contribution rather than defined benefit schemes has also been accelerated by the process, the increased costs to employers had also meant that the tendency had already been in place in the early 1990s. **Based on figures compiled by the Government Actuarial Department there had already been a sharp fall in participation in defined benefit schemes between 1990 and 2001 prior to FRS 17.**

I should like to conclude where I started by re-iterating the importance of transparency and an accurate assessment of future pension costs. It is the basis on which a free economy, or specifically how the stock market, best allocates capital. **But it also seems to me that a snapshot approach in increasingly volatility also potentially works in reverse. And defined benefit schemes tend to be more prevalent in the old industries, who are not growth companies, but more value orientated dividend payers. It would be a shame if noise disrupted the painful transition many of these companies in the United States are currently facing from developing market competition.**

Senator DEWINE. Ms. Bailey?

Ms. BAILEY. Thank you very much. Chairman DeWine, Ranking Member Mikulski, and other members of the committee, thank you for the opportunity to speak with you today.

My name is Sallie Ballantine Bailey and I am the Senior Vice President and Controller of the Timken Company. Part of my responsibility is to oversee all financial aspects of the company's defined benefit and defined contribution plans, and I agree with your committee that there is an urgent need for pension reform in the United States.

Today, however, I come as a spokesperson for the National Association of Manufacturers in conjunction with the American Benefits Council, Business Roundtable, ERISA Industry Committee, and the U.S. Chamber of Commerce. On behalf of these organizations, I am

here as a single voice to emphasize the need to strengthen our Nation's voluntary employee-sponsored defined benefit system.

For decades, the Timken Company has sponsored defined benefit plans for our associates. Currently, 29,000 of our active and retired associates are covered by benefit plans. In 2004 alone, we contributed $189 million to our plans and paid more than $140 million in pension benefits. Our benefits are, and will continue to be, an important part of a comprehensive benefit program to attract and retain talented associates.

Approximately 34 million Americans who work in a variety of industries rely on voluntary single-employer defined benefit plans. These plans are a critical element of their retirement security. We know that in the absence of these plans, fewer Americans will be financially prepared for retirement and more Americans will need to rely on the country's already strained Federal entitlement programs.

In short, the need for reform is clear and we commend this administration for recognizing that fact and we support some aspects of their package. However, we have serious concerns about many other parts of the proposal.

We are concerned that the administration's reform effort is focused on reducing the deficits of the PBGC. Although it must be protected, we cannot lose sight of the fact that the PBGC was established to enhance retirement security. It would be an unfortunate decision to strengthen the PBGC while weakening the entire voluntary defined benefit system. We believe that unwarranted increases in PBGC premiums would be a detriment over the long-term because it would divert cash from pension contributions and investments in plant, property, and equipment, research and development, and hiring new employees.

The PBGC has stated that it has enough funds to meet current needs, which is why we should take time to make sure that we are examining all the actions. We believe that, as a whole, the administration's package would do more harm than good. It is critical to find an appropriate balance between protecting the PBGC and strengthening the voluntary defined benefit system.

We believe, overall, the administration's proposal would burden pension plans with unwarranted PBGC premium increases. The proposal's premium hikes are potentially enormous, and if adopted, the premium will cause operating cash flow that could be used for pension contributions, capital investments, and R&D to be diverted to the PBGC.

We dramatically reduce the predictability and funding of premium obligations. The long-term corporate bond rate adopted by Congress last year must be made permanent. The proposal to use a spot interest rate to value pension liabilities would make pension rules even more volatile and unpredictable, and it wouldn't improve plan funding or accuracy. It would only interfere with our ability to develop reliable business plans.

It would introduce a counterproductive use of credit ratings. An employer's credit rating is not directly tied to their pension plan. Pension assets are held in a separate trust, usually by a bank. Credit ratings are not a good indicator of a company's ability to make pension contributions. Think of it in simpler terms. If a

homeowner temporarily loses his or her job, does having that knowledge give the lender the right to automatically increase the interest rate and payoff amount on the mortgage loan?

It creates a strong disincentive to prefund. We support reforms to the credit balance provision, but as it stands now, the proposal eliminates credit balances. We should be encouraging employers to make extra contributions in good times so they will have a cushion for the bad times. A fully funded defined benefit plan is less expensive in terms of cash requirement and its income statement impact than an underfunded plan.

The Timken Company and the organizations we are representing today strongly believe that the administration's proposal comes with very negative consequences for the retirement security of American workers. Furthermore, the restrictions placed on employers under these proposals would only force them to exit the system. In some cases, it could tip some employers into bankruptcy, costing American workers not only their retirement savings, but their jobs.

Mr. Chairman and members of the committee, thank you for the opportunity to present our views. We look forward to working with you on developing solutions to the long-term funding challenges facing our pension system. The time is now to have a full debate on pension funding. It is extremely important to be sure that the issue of PBGC premiums is included in the overall pension reform, not in the Federal budget, and we must remember that our pension policies must be driven by what is best for American workers, American retirees, and employers.

Thank you for your consideration.

Senator DEWINE. Ms. Bailey, thank you very much.

[The prepared statement of Ms. Bailey follows:]

PREPARED STATEMENT OF SALLIE BALLANTINE BAILEY

Chairman DeWine, Ranking Member Mikulski, and members of the subcommittee, thank you for the opportunity to appear before you this morning on this critical issue. I appreciate the opportunity to discuss the challenges facing our Nation's defined benefit system, as well as, the reforms that can meet these challenges.

My name is Sallie Ballantine Bailey. I am the Senior Vice President-Finance and Controller for The Timken Company, which is a leading global manufacturer of highly engineered bearings, alloy steels and related products and services. Timken has operations in 27 countries, sales of $4.5 billion in 2004 and employs 26,000 associates worldwide.

Today, I am serving as a spokesman for the National Association of Manufacturers and on behalf of the American Benefits Council, Business Roundtable, the ERISA Industry Committee and the U.S. Chamber of Commerce. These organizations are steering committee members of The Pension Coalition, a broad based business coalition which is dedicated to advancing retirement security through voluntary employer-sponsored plans. We come before you today with a single voice to emphasize the need to strengthen our Nation's voluntary, employer-sponsored defined benefit pension system.

The administration has stepped forward with proposals to reform the pension funding rules and the premiums payable to the Pension Benefit Guarantee Corporation (PBGC). 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 measures to allow employers to make larger contributions during good economic times are long overdue. Improved disclosure rules would also be beneficial. Meaningful safeguards should also be considered to protect the PBGC from benefit enhancements adopted at a time when the plan sponsor is unlikely to properly fund those enhancements.

At the same time, we are concerned that much of this reform effort is focused on reducing the deficits at the PBGC. Although the PBGC must be protected, we cannot lose sight of the fact that the PBGC was established to protect retirement secu-

rity in the defined benefit system. It would be a distressing calamity if the PBGC was strengthened but the entire defined benefit system was weakened. We believe that the administration's pension funding scheme will do far more harm than good. Taken as a whole, the administration's package could have grave consequences for the millions of Americans who rely on defined benefit plans for their retirement security. It will be critical for Congress to find an appropriate balance between protecting the PBGC and strengthening the defined benefit pension system.

Pension plans play a vital role in the lives of American workers and retirees. Across the country, some 34 million Americans rely on single-employer, private-sector defined benefit pension plans as a critical element of their retirement security. More than 18 million of these Americans are active workers from a diverse range of industries. Single-employer defined benefit plans paid benefits to retired workers and their families of more than $120 billion during 1999 (the most recent year for which official Department of Labor statistics have been published). In the absence of defined benefit pensions, it is certain that fewer Americans would be financially prepared for retirement, more American seniors would live in poverty, and many more Americans would be forced to rely even more heavily on already strained Federal entitlement programs.

For decades, The Timken Company has sponsored defined benefit pension plans to provide for our associates' retirement security. Over 29,000 of our active and retired U.S. associates are covered by defined benefit pension plans. In 2004 alone, we paid $189 million into our plans and made payments to retired participants in excess of $140 million. We are proud of our pension plans and look forward to maintaining them for years to come.

That reforms are needed is clear. Employers have been exiting the defined benefit system in alarming numbers in recent years. Just since 2001, nearly a quarter of Fortune 1000 companies announced their decision to either freeze or actively consider freezing their defined benefit pension plans. Both terminations and freezes have truly unfortunate consequences for American workers—current employees typically earn no additional pension benefits and new hires have no defined benefit program whatsoever.

The primary factors driving this trend are uncertainty regarding funding obligations; barriers to contributing during good times; and the lack of clear guidance on cash balance and other hybrid plans. Reforms are needed to address these issues and encourage employers to stay in the voluntary defined benefit plan system. We support taking the following steps:

Five Pension Reform Proposals That Would Improve Retirement Security

- **Make the Long Term Corporate Bond Rate Permanent.** The best way to protect the pension system for future retirees is to make permanent the long-term corporate bond rate that Congress adopted last year. The long-term corporate bond rate reflects a conservative and realistic rate of return that will provide an economically sound measure of future pension obligations.
- **Allow Employers to Contribute to Plans During Good Economic Times.** Barriers that prevent employers from making contributions to their plans should be eliminated. Reforms are needed to rules that prevent employers from contributing. In the past, The Timken Company would have liked to contribute more, but ultimately was forced to limit contributions to the maximum amount that would be tax deductible.
- **Adjust Credit Balances For Real Market Returns.** Credit for prefunding ("credit balances") encourages companies to fund their plans during good times, which helps employers better plan their product investments, accelerates plan funding and reduces risk to the PBGC. However, plans with poor investment results have been able to use credit balances to meet their minimum required contributions. We support reforms to the application of credit balances.
- **Provide Timely and Appropriate Disclosure.** Participants should have timely and meaningful funding information on their retirement plans. Reforms are needed to provide full and fair disclosure without creating undue administrative burdens or unnecessary concerns among participants.
- **Confirm the Legality of Hybrid Plan 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 as of the year 2000. It is critical that Congress confirm the legality of hybrid plan designs.

These reforms will help create a robust and sustainable defined benefit plan system. As mentioned above, there are a number of elements of the administration's proposals that are consistent with our reform proposals. For example, we both agree that better disclosure to plan participants is needed. Similarly, we support proposals

to change the tax rules to permit employers to contribute more to their plans when they have the ability to do so.

Top Four Concerns With the Administration's Proposals

However, we have serious concerns about other elements of the administration's proposals. Our primary concerns are that the administration's proposals would:

- **Dramatically Reduce the Predictability of Funding and Premium Obligations.** The administration's proposal to use a spot interest rate to value pension liability and mark-to-market treatment of assets would make the funding rules even more volatile and unpredictable than they already are, without improving accuracy or plan funding. This would severely handicap the ability of employers to make long-term business plans.
- **Introduce a Troubling and Counterproductive use of Credit Ratings.** The administration's proposal to base contributions and PBGC premiums on credit ratings would create the potential for a vicious downward corporate spiral. Lower credit ratings that increase funding liability, premium burdens and business pressures could lead to further downgrades, creating a vicious circle that drags a company down and prevents its recovery.
- **Create a Strong Disincentive to Fund.** Employers need to be encouraged to make extra contributions in good times so that they will have a sufficient cushion for the bad times. We support reforms to the credit balance provisions. The administration's proposal to eliminate credit balances would discourage employers from making extra contributions except in unusual circumstances. It goes without saying that such a restriction would be a major step backward.
- **Burden Pension Plans with PBGC Premium Increases That are Unwarranted.** No one denies that the PBGC faces a serious situation. However, the PBGC's unspecified but potentially enormous increase in premiums could be devastating for many plans, particularly plans sponsored by midsize to smaller employers.

Taken as a whole, we believe the administration's proposals would have very adverse consequences for the retirement security of American workers. The additional barriers, risks and burdens under the administration's proposals will only force employers to exit the system through plan freezes and terminations, thereby eroding the retirement security of American workers. In the worst case, the administration's proposals could tip some employers into bankruptcy—costing those workers not only their retirement savings but potentially their jobs.

We owe it to American workers and their families to ensure that changes, no matter how well-intentioned, are not counter-productive. We support proposals strengthening, without tearing down, a system that is a core part of how employers provide, and millions of Americans receive, retirement income security.

We also owe it to American workers and their families to have a full debate on pension funding reform. In recent weeks, there has been discussion of including proposed increases in the premiums payable to the PBGC in the fiscal year 2006 budget resolution. The House budget resolution, for example, appears to contemplate premium increases of $18 billion over the next 5 years—which is effectively a tax increase of over 240 percent for companies maintaining defined benefit plans. Setting premium increase targets in the fiscal year 2006 budget resolution will make a full examination of pension funding reform virtually impossible. Pension funding and PBGC premiums are inextricably intertwined. Changes to PBGC premiums should only be considered in conjunction with changes to the funding rules as a whole. Any premium increases to hit budget targets will only handicap reform discussions. Excessive and unreasonable premium increases in the budget resolution would inevitably put short-range budget objectives ahead of the long-term retirement security that is needed. The budget process is simply the wrong place to make comprehensive pension law and we urge you to not include premium increases in the fiscal year 2006 budget resolution. Pension policy must be driven by what is best for American workers and retirees, not by the need to fill an arbitrary hole in the Federal budget.

The remainder of this testimony describes the reforms that we believe should be enacted and highlights our concerns with the administration's pension reform proposals.

Funding the PBGC Appropriately

The financial stability of the PBGC is important but not at the expense of the health of the defined benefit system overall. To put this in perspective, private sector defined benefit pension plans pay more than $110 billion in benefits to retirees every year. By comparison, in 2004 the PBGC paid just over $3 billion in benefits. Similarly, over 44 million Americans receive or will receive benefits from defined

benefit plans, while the PBGC's present and future benefit population at the end of 2004 was only 1 million. It is critical that any reforms target the specific problems. The vast majority of defined benefit pension plans are not a threat to the PBGC—but onerous and volatile rules will threaten the vast majority of plans and the companies that sponsor them.

The administration has proposed dramatic increases in premiums to address the PBGC's reported 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 well-funded plans 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. 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. Many of these plans are well-funded by any other measure, but under the administration's proposal might be deemed "underfunded" and now be required to pay variable rate premiums on top of the higher base premium. 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. A premium increase misses the point. The solution to underfunding is better funding rules, not higher premiums.

We are very concerned that PBGC premium increases not become a tool used to reduce the Federal budget deficit. The administration's fiscal year 2006 budget reflects a $26 billion increase in revenue attributable to the PBGC's premium increase. Proper pension policy should be driven by what is best for American workers and retirees, not by the need to fill an arbitrary hole in the Federal budget.

In addition, 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 fiscal year 2004 but there are a number of questions about the PBGC's situation. First, nearly three quarters ($17 billion) of the PBGC's reported deficit represents "probable" terminations rather than claims from plans already trusteed by the PBGC. Second, the PBGC's numbers are based on a below-market interest rate. The deficit would be substantially less using a market-based interest rate. Third, swings in the PBGC surplus-deficit do not provide Congress with an accurate picture of the PBGC's ability to pay benefits. In fact, the PBGC can pay benefits for many, many years into the future. 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 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.

The best way to ensure a stable defined benefit system is to encourage plan sponsors to remain in the system, not to make the system so costly that they cannot afford to stay. The proposed substantial increase in the flat premium and the potentially huge increase in the variable rate premium will force plan sponsors to divert resources to the PBGC and away from pension plan contributions, capital investments, job creation, research & development and other growth activities.

Make the Long Term Corporate Bond Rate

Since last year, a long-term corporate bond rate averaged over 4 years has been used to determine "current liability" for the funding and deduction rules and to determine unfunded vested benefits for purposes of PBGC variable rate premiums. However, the measurement rate defaults to the rate on the now defunct 30-year Treasury bond beginning in 2006 if no further action is taken. It is widely agreed that the 30-year Treasury bond is no longer a realistic measure of future liabilities and would inappropriately inflate pension contributions and PBGC variable rate premiums. A return to an inappropriate and inaccurate measure of pension liabilities and the resulting inflated contributions caused by the defunct 30-year Treasury bond rate would be devastating for the ongoing vitality of defined benefit plans. It would be enormously disruptive for plan sponsors who must be able to project future cash flow demands as a part of prudent business planning. The uncertainty of the interest rate in effect today severely hinders effective planning and could curtail economic growth.

We strongly believe the best way to support and enable the defined benefit pension system is to make permanent the 4-year weighted average of the long-term corporate bond rate that Congress adopted last year. As Congress has already recog-

nized, the long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. It reflects a very conservative estimate of the rate of return a plan can be expected to earn and thus is an economically sound and realistic discount rate.

The administration has proposed, as an alternative to both the 30-year Treasury bond rate and the long-term corporate bond rate, a near-spot rate "yield curve" comprised of conservative, high-quality corporate bonds. We agree with the administration that there is a compelling need for a permanent interest rate so that employers can project their future contribution obligations and make long-term business plans. In addition, we agree that the permanent interest rate should be based on high-quality corporate bonds. However, we have serious concerns about four aspects of the administration's "yield curve" proposal. First, the yield curve interest rate is a "near-spot rate" rather than a 4-year weighted average rate. It will saddle employers with unpredictable and potentially volatile funding obligations. 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. This is an unnecessarily complex methodology. Third, we are concerned that the administration's mechanisms for creating interest rate assumptions would require excessive and unnecessary contributions for some mature plans, which could be very harmful for employers, workers, and the economy. Fourth, the proposed yield curve is opaque and will be difficult for businesses to use in long-term planning and for Congress to oversee. We discuss these concerns in more detail below.

Preventing the Volatility That Would Be Created by Spot Valuations

Our primary concern with the administration's yield curve proposal is the use of spot valuations. Companies need to be able to make business plans based on cash flow and liability projections. Volatility in pension costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these contribution obligations be predictable. The essential elements facilitating predictability under current law are use of the 4-year weighted average of interest rates and the ability to smooth out fluctuations in asset values over a short period of time (subject to clear, longstanding regulatory limitations on such smoothing). The administration's yield curve proposal would, however, eliminate both smoothing elements, dramatically increasing the volatility and unpredictability of funding requirements.

Let us be clear—spot valuations do not mean tighter funding standards. The spot or smoothed rate only relates to when contributions are due. As interest rates rise, a spot rate will result in smaller contributions and vice versa. Over the long-term—which should be the focus in pension funding—contributions will essentially be the same regardless of whether a spot or smoothed rate is used. Similarly, the value of pension assets will essentially be the same over the long term, regardless of whether spot or smoothed asset valuations are used. Further, spot valuations would not add any appreciable accuracy. Pension liabilities span many years and spot valuations are not meaningful for these liabilities. A spot interest rate for 90 days is simply not a particularly accurate measure of liabilities that in many cases span more than 40 years.

Spot rates would also have very negative implications for the U.S. economy. Spot valuations likely would require larger contributions during economic downturns and smaller contributions during economic upturns. Larger contributions reduce capital spending. This exaggerates downturns and upturns. The result is that the economy overheats during upturns and has deeper recessions during downturns. The two key elements of smoothing under the current rules provide a significant counter-balance to this phenomenon, and should be preserved.

Some have suggested that sponsors of defined benefit plans can manage the spot rate by investing in bonds and financial derivatives that hedge against interest rate movements. Hedging in this way would be very expensive. Plans should not be effectively forced to incur this cost. 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, the overall costs for plan sponsors will rise. As plans become more expensive, it goes without saying that there will be fewer plans remaining and that the heightened cost will discourage employers from increasing benefits in the plans that do remain.

Further, if a 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 could have a marked effect on the stock market, the capital markets, and capital formation. At the end of 2003, private-sector defined benefit plans held equities worth about $900 billion and the market impact of a portfolio shift of this magnitude is extremely difficult to predict.

It is far from clear whether plans can insulate themselves from both volatility and liability by investing in bonds. First, it is doubtful that there could ever be enough high-quality corporate bonds, particularly at the long durations that characterize pension liabilities. Second, even if there were enough high-quality bonds to go around, it is not possible to immunize all risks. Even the staunchest bond proponents acknowledge that there are numerous pension liabilities that cannot be accurately anticipated. For example, because mortality cannot be predicted with precision, it is not possible to shield 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 protected against.

Avoiding Unnecessary Complexity and Lack of Accountability

We are concerned that the administration's yield curve would add significant complexity without providing any real benefit. The proposal would generate numerous and different interest rates for each participant. This level of complexity could be managed by some large companies but it will impose an unjustifiable burden on small and mid-sized companies across the country.

Further, we are concerned that the interest rate constructed by the Treasury Department would be opaque. 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. Considerable discretion is exercised in creating a yield curve and, in some respects, it appears to be as much art as science. This type of a discretionary, non-market interest rate would be virtually impossible for employers to model internally as part of corporate planning and would also be particularly difficult for Congress to oversee.

Ensuring Appropriate Funding

We are deeply concerned that the yield curve aspect of the proposal could produce an effective interest rate for some plans that is too low and therefore will overstate liability. Relative to the weighted long-term corporate bond rate in effect this year, the administration's proposal could increase pension liabilities for some mature plans by 10 percent or more. In some cases, the immediate liability increase could be even greater. Using a lower effective discount rate than the long-term corporate bond rate could result in contributions that far exceed what is needed to pay benefits. Excessive contributions are in no one's interest, especially for mature plans in industries that can least afford to have a sudden required increase in funding obligations.

The consequences of excessive contribution obligations are painfully clear. This is precisely what happened when inflated pension contributions were mandated by the obsolete 30-year Treasury bond rate. Employers that confront inflated contribution obligations will have little choice but to stop the financial bleeding by freezing or terminating their plans. Both terminations and freezes have truly unfortunate consequences for workers—current employees typically earn no additional pension accruals and new hires will not be able to participate in a defined benefit plan. Government data reveals that defined benefit plan terminations accelerated prior to the temporary long-term corporate bond rate fix in the Pension Funding Equity Act of 2004, with a 19 percent drop in the number of plans insured by the PBGC from 1999 to 2002. Just as troublesome, the statistics above do not reflect plans that have been frozen. While the government does not track plan freezes, reports make clear that these freezes are already on the upswing.

Further, inflated pension contributions divert precious resources from investments that create jobs and contribute to economic growth. In fact, a recent study by Business Roundtable concluded that the use of a spot rate during 2003 would have cost the economy approximately 300,000 jobs. Facing pension contributions many times greater than they had anticipated, employers will not hire new workers, invest in job training, build new plants, and pursue new research and development. Furthermore, inflating pension liabilities and forcing unnecessary contributions would drive up the cost of doing business and will put U.S. companies at a further competitive disadvantage relative to foreign corporations that do not have similar obligations. For these reasons, it is important for funding to remain rational, predictable, and stable. These are precisely the steps that would help lower our Nation's unemployment rate, spur individual and corporate spending, generate robust economic growth, and keep U.S. companies competitive in the global marketplace.

Preventing Unnecessary Bankruptcies

It is important to recognize that an employer's credit rating is not directly tied to the ability of the sponsor of a defined benefit plan to provide promised benefits. Corporate debt is not the same as pension obligations. The pension plan is a separate entity. One of the hallmarks of U.S. pension law is that pension assets must

be held in a separate trust or similar dedicated vehicle. The ability of a company to continue to make benefit payments and appropriate levels of contributions is not determined by its credit rating. A plan that has sufficient assets to pay benefits will pay those benefits even if the plan sponsor does not have adequate assets to pay its debts or has debt that is rated below investment grade.

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. The administration's package of proposals creates a serious risk of potentially forcing unnecessary bankruptcies on "at risk" companies that could have otherwise continued to fund their pensions for many years. Its proposals to trigger variable funding rules and base PBGC premiums and benefit guarantees on the determination of the creditworthiness of the plan sponsor and the members of the sponsor's controlled group are wrongheaded. In effect, the employer's liability is treated as increasing when the employer's credit rating slips, even though the plan's benefit payment obligations remain unchanged.

Forcing "at risk" employers to fund their plans based on termination liability is not appropriate. Termination is not relevant to an on-going plan, especially if the plan sponsor is not going bankrupt. On the consumer side, this proposal is analogous to the relationship between a mortgage lender and homeowner. If the homeowner receives a job-related demotion, does having that knowledge give the lender the right to automatically increase the interest rate and payoff amount on the mortgage loan? The use of credit ratings to determine funding or PBGC premium obligations could have significant macroeconomic effects. Such use would put severe additional pressures on employers experiencing a downturn in their business cycle. If the lower credit ratings create additional funding burdens and business pressures, which could lead to further downgradings, creating a vicious circle that further drags a company down. This could well happen to a company that today is able to fund additional contributions to pull itself out of the underfunding problem and thus raise its credit ratings. In short, a creditworthiness test would make it more difficult for a struggling company to recover. That is not in anyone's interest, including the PBGC, which could be forced to assume plan liabilities if the company does not recover. We must be careful not to lose sight of the fact that the best insurance for plans, participants and beneficiaries, and for the PBGC is a healthy plan sponsor. The best way to protect the PBGC is to ensure that plans are appropriately funded, regardless of the plan sponsor's credit rating.

It is also clear that the PBGC's proposal would classify many plans as at risk that will never be terminated. The mere fact that a company's debt is not rated as investment grade does not mean that it will terminate its plans. However, the consequence of these "false positives" could well be self-fulfilling, with employers forced to terminate as a result of a downward spiral. Moreover, employers that have non-investment grade debt but are improving their situation would get no credit for such improvement.

Finally, a creditworthiness test would inevitably result in the government determining the creditworthiness of at least some American businesses. Many privately held employers are not rated by any of the nationally recognized agencies. The PBGC has recommended conferring regulatory authority to develop guidelines for rating private companies. This would be a disturbing and far-reaching expansion of the PBGC's authority beyond its original legislative intent.

Eliminating Prefunding Barriers

One aspect of the administration's proposal that we strongly support is the proposal to reform the tax rules governing the deductibility of pension plan contributions. Specifically, we support the administration's proposal to increase the deduction limits 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. We propose that current liability should 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 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.

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. 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 because, in a mature plan, the number of active participants is small compared to the number of retired participants. 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.

Encouraging Advance Funding

We are concerned about elements of the administration's funding proposal that could discourage employers from contributing more than the minimum required contribution. Under current law, if a company makes a contribution in excess of the minimum required contribution, the excess plus interest can be credited against future required contributions. This credit for prefunding ("credit balances") helps to mitigate volatile and unpredictable funding requirements by allowing and encouraging a sponsor to increase funding during good times. The proposal, however, does not give employers who prefund direct credit for their excess contributions.

There have been suggestions that the current law credit balance system has been a factor in terminating plans assumed by the PBGC. These suggestions ignore the fact that but for the credit balance system, companies would have contributed less, resulting in more underfunding and more liabilities assumed by the PBGC.

Critics have pointed out that credit balances are not immediately adjusted if the underlying value of the assets decreases. Consequently, plans with poor investment results have been able to use credit balances that are larger than the assets they represent. We support carefully targeted reforms that address this investment result problem. These reforms must be administrable and need to be applied prospectively. It would be fundamentally unfair to change the rules retroactively for employers that made contributions in reliance on current law credit balance rules. It is critical, however, that we preserve appropriate incentives to advance fund. Without these incentives, there is a significant risk that employers will only pre-fund to the minimum required by law. The result would be a less well-funded system, which is in no one's interest.

Providing Timely and Appropriate Disclosure

We believe that participants should have timely and high-quality data regarding the funded status of their plans. It is important that participants have the information they need to evaluate their retirement security. These rules should be structured to provide full and fair disclosure without creating undue administrative burdens on plans or causing unnecessary alarm among participants.

In this context, existing disclosure requirements should be enhanced, while at the same time avoiding the creation of costly and confusing new requirements. A starting point might be the administration's general proposal to improve the summary annual report ("SAR"), but with significant modifications that would make the information disclosed more immediate and more meaningful. One of the problems with the SAR under current law is that the information disclosed is not timely, a problem which is not addressed by the administration's proposal. In fact, the information currently provided can be almost 2 years old.

One possible solution would be to require plans to disclose in the SAR their funded percentage. However, instead of reporting percentages as of the first day of the plan year for which the SAR is provided (information that is almost 2 years old), the percentage could be reported as of the first day of the subsequent year, using (1) the fair market value of assets as of that date and (2) the liabilities as of that date based on a projection from the preceding year. This would mean more timely disclosure. A plan maintained by a public company could also be required to disclose the year-end funded status of the plan as determined for purposes of financial accounting for the 2 most recent years available. This approach would provide much more information than under present law or under the administration's proposal. In addition, unlike the administration's proposal, financial accounting information that is already circulated and disclosed for the company as a whole could be

disaggregated into the amounts for individual plans and provided to participants. By using information available to employees through financial reports and media statements, the possibilities for confusion would be greatly reduced.

Confirming the Legality of Hybrid Plan Designs

Hybrid defined benefit pension plans, such as cash balance and pension equity plans, were developed to meet the needs of today's mobile workforce by combining the best features of traditional defined benefit plans and defined contribution plans. 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 as of the year 2000. These plans are defined benefit plans and many of the same funding issues described above are relevant. They also face unique issues.

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 eliminated. Legislation is needed to clarify that the cash balance and pension equity designs satisfy current age discrimination and other related ERISA 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.

Some legislators propose imposing specific benefit mandates when employers convert to hybrid pension plans. For example, they would require that employers pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others would require employers to provide employees the choice at the time of conversion between staying in the prior traditional plan or moving to the new hybrid plan. We strongly urge you to reject these mandates. Mandates are fundamentally anathema to the voluntary nature of our employer-provided retirement system. Inflexible mandates will only drive employers from the system and reduce the competitiveness of American business. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans.

Conclusion

Mr. Chairman and members of the committee, thank you for the opportunity to present our views. We look forward to participating with the committee in a comprehensive discussion of the long-term funding challenges facing our pension system and proposals to provide additional protection to the PBGC. Our Nation's defined benefit system stands at a cross-roads. There are reforms that will revitalize the system and there are reforms that will be too much for the system to bear. We owe it to American workers and their families to ensure that any reforms preserve a robust defined benefit system well into the future.

Senator DEWINE. Mr. Gebhardtsbauer, thank you for joining us.

Mr. GEBHARDTSBAUER. Thank you, Mr. Chairman and distinguished committee members. Thank you for inviting us to testify on these important issues. I am Ron Gebhardtsbauer and I am a Senior Pension Fellow at the American Academy of Actuaries.

I will first address your questions on the PBGC deficit. Most of PBGC's $23 billion deficit last September 30 was from probable terminations, and a good portion of it could have been avoided if the law allowed two things: One, freezing the guarantees in those pension plans, as suggested by the administration, but in addition, also allowing PBGC to work out pension financing deals with weak employers. Currently, PBGC's only recourse is to take over the pension plan, which is a very costly remedy. It would be very valuable if Congress could fix this remedy soon, along with enacting a permanent interest rate.

You also asked about the effect of large increases in PBGC premiums. Some employers will respond by funding their pension plans quickly to 100 percent, which is a good result, but it will result PBGC's premium income. In fact, many healthy companies will go further and eventually terminate their pension plans, which

would further reduce PBGC's future income. It will not be easy to pay off this $23 billion deficit.

With respect to pension funding, the Academy is encouraged that the administration has taken significant steps in framing reform. Its use of one funding rule improves transparency and simplicity. Solvency is improved by targeting 100 percent funding levels and allowing greater deductible contributions. However, while the use of the one funding rule eliminates a funding cliff, which is very helpful, the proposal would still have volatility anyway due to requiring the use of market assets and only 90-day smoothing of average interest rates. Solvency is of paramount importance, but unless volatility and predictability are also addressed, many employers will terminate their defined benefit pension plans.

For example, if the proposal were enacted, you could go to tell your CEO just before the year-end holiday that there will be no contributions next year. However, if the stock market values drop by 33 percent around the year end, as they did in October 1987, you would have to call up your boss, the CEO, on January 1 and tell him that there will, in fact, be a required contribution next year, and in fact, it will be bigger than any contribution your company ever paid to the pension plan. That is right after you had told him that there maybe wouldn't be a contribution at all next year.

Our first chart over here on my left shows similar volatility problems with interest rates. In 1986, the 30-year Treasury rate fell by a huge 1.8 percent, or 180 basis points. Unfortunately, the 90-day average fell even more. It fell 260 basis points. Thus, 90-day averaging would not reduce volatility, as intended. It would exacerbate it in this particular case. Even 2-year smoothing has this problem.

Employers could reduce these problems by holding more assets in bonds, as has been discussed already, and that could increase participant shareholder value. However, many employers have told us they would rather freeze and terminate their DB pension plans than move to bonds because getting just the low returns on bonds could make their pension plans too expensive. These terminations would have negative repercussions for national retirement security, for the markets, for employers, for employees, and the PBGC. This outcome can be avoided, though.

The green line on the second chart, notice how it—this is for a pension plan that was, say, about 60 percent funded, and the green line shows that if the proposal had been in effect in the past, the minimum contribution would have fallen to zero abruptly in 1997. This is under the administration's rules. They would fall to zero. And then they would jump back dramatically in 2001 and 2002.

Senator MIKULSKI. What is the green line? We don't have a green line.

Mr. GEBHARDTSBAUER. Oh, okay. The green line is the administration proposal and it shows what the minimum contributions would have been if it had been enacted over the last 10 years. So initially for this particular plan, it would have been high and fallen to zero dramatically so that a strong company could put in more, but a weak company would just put in what the very bare minimum is. It would fall to zero, and then it would jump back up in 2001.

Congress could reduce this volatility and improve predictability and improve solvency by doing three things. One, they could smooth funding ratios or assets and liabilities; or two, they could place a cap on very large changes in the minimum contribution; and three, they could shorten the amortization period. In fact, the red line shows possibly a better way of doing this. It actually gets a better solvent plan by smoothly reducing the contribution instead of all of a sudden dropping it to zero, and then when the stock market did well, they smoothly bring it back up. And in that particular case, a company that paid in contributions under this red line, the pension plan would always be more solvent, always be better funded than under the administration proposal.

Another problem with eliminating smoothing is that many other pension rules would become unpredictable, such as quarterly contributions and the onset of benefit freezes, and these problems could be reduced by smoothing funding ratios or triggering provisions only if the pension plan was funded below a certain threshold for 2 years in a row, and also giving employers an opportunity to cure the problem through contributions or security.

Finally, as my time is short, I see, I will just quickly mention two final concerns. One, some employers have already stopped contributing to their pension plan because of the current proposal eliminating credit balances.

And number two, greater deductible contributions in the proposal are a very good idea, but they won't work unless employers get some economic value for super-surpluses in their pension plans, and I can explain these later in Q&A.

Thank you very much for the opportunity to speak.

Senator DEWINE. Thank you very much.

[The prepared statement of Mr. Gebhardtsbauer follows:]

PREPARED STATEMENT OF RON GEBHARDTSBAUER, MAAA, EA, FCA, FSA

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

AN ANALYSIS OF THE ADMINISTRATION'S SINGLE EMPLOYER PENSION FUNDING PROPOSAL

Thank you, Chairman DeWine and ranking member Mikulski, for inviting me to testify on reform of the Pension Benefit Guaranty Corporation (PBGC), as well as other aspects of the administration's single-employer pension funding reform proposal.

The Pension Practice Council of the American Academy of Actuaries believes that a healthy defined benefit (DB) system is essential to the financial security of our Nation's retirees. The financial status of the PBGC is one of a number of crucial elements that needs to be addressed as part of a larger focus on pension reform. Within the context of the following analysis of the administration's funding reform proposal, we address many of the issues relevant to this hearing.

The administration's recent proposal reflects many of the funding reform principles discussed in our paper, *Pension Funding Reform for Single Employer Plans*;[1] namely: solvency, predictability, transparency, incentives for funding, flexibility, avoidance of moral hazards, and simplicity. In particular, their proposed use of one funding rule and one amortization period improves transparency and simplicity.

Flexibility is enhanced by their provision to increase the maximum deductible contribution. In addition, they eliminate rules that currently allow sponsors of underfunded plans to avoid paying contributions and variable premiums.

However, the proposal may cause employers to decide their only viable alternative is to freeze and/or terminate their pension plan due to concerns that their minimum required pension contributions could become too volatile and unpredictable.[2] Plan terminations would have negative repercussions for national retirement security, the markets, employee morale, the PBGC,[3] and an employer's ability to manage its workforce. This outcome can be avoided. In this statement, we identify how some of these concerns can be addressed to ensure a strong pension system.

Solvency

Funding targets: The administration's proposal sets a funding target of 100 percent of accrued benefits and increases the funding target if the credit rating of the plan sponsor falls below investment grade status. However, the additional funding to the administration's "at-risk" liability may be too late, because a company may already be too weak to make the additional contributions. Unfortunately, healthy companies may balk at funding to the higher "at-risk" liability because the additional funds may never be needed, nor could they be accessed without paying prohibitive taxes of over 90 percent.

Funding margins: Rather than creating a different structure of liability calculations for companies with low credit ratings, Congress could devise a set of funding rules that naturally lead toward the creation of a funding margin. For example, once the funding level exceeds the initial target liability, a minimum contribution (e.g., the normal cost) could be required until assets reach the "at-risk" liability or the accrued liability with salary projection (as in current law). This would create funding margins, which are what kept traditional salaried plans so much better funded than hourly plans in the past; encourage funding discipline; and avoid the need for ratings. Alternatively, the normal cost could be phased out by $1 for every $5 of surplus instead of for every $1 of surplus as in the administration proposal. This would also build a funding margin and help the employer avoid volatile minimum contributions.

At-risk liability: The administration's proposal determines the funding target for weak companies using an assumption that all employees will retire as soon as possible.[4] However, this may not represent the most valuable benefit. For example, in many pension plans, the earliest possible benefit is payable at age 55, while a much more subsidized retirement benefit may be payable at the employee's 30th year of service, which might occur at a later age. If this subsidized benefit occurs soon after age 55, the employee may very likely delay retirement in order to the get the subsidy. Fortunately, the administration proposal would require the use of the actuary's best estimate of the liability, if it is greater than the prescribed liability. This may solve the problem of potentially undervaluing the at-risk liability.

Assumption setting: History has shown that using the law and regulations to specify actuarial assumptions has not been successful, as evidenced by the delays in setting the discount assumption and the continuing debate on replacing the currently required 1983GAM mortality table. We recommend that the law allow actuaries to set the mortality assumption, since it differs by plan. The law and actuarial standards both now require each assumption to be individually reasonable, which is a major change from when Congress first started specifying assumptions. If there are concerns, then actuaries could be required to justify their assumptions in writing if they seem out of the ordinary.

Valuation dates: We do not understand why the administration's restriction on valuation dates needs to be imposed. If anything, it is hoped that more plans could use prior year valuation data[5] (along with year-end market assets), in order for companies and associations to budget in advance for their contributions and to disclose funded status information to participants in a more timely manner.

Predictability and Hedgeability

The administration's 90-day smoothing provision will cause problems for both sponsors of bond-immunized pension plans as well as sponsors of diversified stock portfolios. For the immunization sponsors, the 90-day smoothing provision will make it difficult for plans to hedge their liabilities, since bond prices will not rise and fall with liabilities using a smoothed discount rate. (They should be allowed to use market liabilities, just as they can now elect to use market assets.) For the diversified stock portfolio sponsors, 90 days does not provide enough smoothing to make contributions predictable. Their contributions will be volatile (and vary greatly depending on the date valued), unless there is some mechanism to reduce the volatility.

Contribution volatility: We suggested the creation of an anti-volatility mechanism (AVM) in the predictability section of our funding reform paper. It would place a cap on large increases in the minimum contribution, such as 25 percent of the normal cost, or 2 percent of the plan's accrued liability, if greater. It would enable faster elimination of underfunding than one might first surmise, because the effect is cumulative. Our analysis shows that the cap would rarely be applied more than 3 years in a row, and that assets could reach the funding target as quickly as the administration's proposal if desired. Other ways to reduce volatility would be to average funding ratios or smooth assets and liabilities.[6]

Reduce cyclical nature of minimum contributions with credit balance: Minimum contributions can be large in difficult times and small (or zero) in good times, which is very hard on employers and exacerbates the cyclical nature of our country's economy. Credit balances can fix this problem by encouraging employers to contribute more in good times, knowing that the excess contribution will enable them to contribute less in difficult times. Eliminating the credit balance would create a powerful disincentive for companies to contribute anything more than the minimum required contribution. For example, if they leave the money on the outside of the plan they get dollar-for-dollar credit for it when they use it to pay the minimum contribution in the following year. However, if they contribute it to the pension plan, they may not get any credit for it the next year because the amortization rules in the administration proposal are so one-sided. At most they would only get 1/7th of the credit. Thus, there would be a tremendous reluctance to take a chance on contributing an additional amount to the plan, if plan sponsors knew that they might need that cash to pay next year's contribution.

Some of the objections to the use of credit balances could be overcome by growing credit balances at the same rate that plan assets grow, instead of at the valuation rate. The other objection is that credit balances allowed several sponsors of distress-terminated plans to avoid contributions right before their plans terminated with insufficient funds to pay all benefits. However, with the above fix, the credit balance provision would only increase the assets in the plan. Taking advantage of a credit balance would only return plan assets back to where they would have been had the employer never contributed more than the minimum. Thus, the objective should be to make sure the minimum funding rules are strong enough, not eliminate the credit balance.

If there is still a concern that credit balances can eliminate contributions to underfunded plans, then a compromise rule could prohibit using the credit balance from offsetting the full contribution when a plan is underfunded. The underfunded plan could be required to pay the normal cost, unless it gets a waiver from the IRS, provides security, or freezes accruals.

Volatile plan design: The administration's abrupt freezing and unfreezing of benefit accruals will make plan administration and employee notification very difficult, disrupt employee expectations, and call on actuaries to estimate liabilities before employee data is available.[7] This problem is exacerbated by having to freeze benefits for certain plans if the actuarial valuation is not completed by a specified time—even if there is nothing in the plan's demographics or assets to indicate that the funding status has deteriorated since the prior valuation.

A remedy to this problem could be to require an accrual freeze only if the funding ratio is less than the threshold for two consecutive valuation dates, and to allow employers to cure the problem by a contribution or security after the first valuation showing a deficiency. Similar rules could also be provided for:

- the Internal Revenue Code (IRC) Sec. 401(a)(29) threshold requiring security for amendments;
- the 100 percent threshold for IRC Sec. 412(m) quarterlies and for having to pay the variable rate premium;
- the 125 percent threshold for IRC Sec. 420 transfers to retiree health plans; and
- the thresholds in IRC Sec. 412(c)(9)(B) which allows use of a prior valuation.

Congress should consider freezing benefits in all plans under the threshold (60 percent in the administration's plan), not just those of weak employers. This would encourage healthy employers to fund their plans when they can, and it avoids the need for the government to rate companies.

Eliminating lump sums will also disrupt employee expectations, and could easily cause a "run on the bank," which not only hurts the PBGC, but also the workers and retirees remaining in the plan. Ways to avoid this problem include:

- Increase the threshold for prohibiting lump sums to 100 percent of target liability (or more). There is less concern about a "run on the bank" in paying a lump sum when a plan is over-funded. Note: the current rules in the Code of Federal Regulations (CFR) 1.401(a)(4)-5(b)(3) already restrict lump sums for highly compensated

employees (HCEs) or the top 25 when funding ratios are less than 110 percent. They could be applied to all HCEs.

- Keep the plan well funded, or require the plan sponsor to contribute the unfunded portion of the lump sum, in addition to the minimum contribution.
- Phase in the lump-sum ban by only allowing payment of the funded portion of the lump sum. For example, if the plan is 90 percent funded, pay 90 percent of the lump sum.
- Allow or require sponsors to eliminate the lump-sum provision without violating IRC Sec. 411(d)(6), as long as it is replaced by a 20-year certain and life annuity. (And allow insurance companies to pay the lump-sum value if the annuitant signs over the pension to the insurer).

Outlawing shutdown benefits in their entirety (as proposed by the administration) may not be necessary in cases where the plan's funding is adequate and/or plan sponsor can cover the increased benefits. These contingent benefits have been responsible for some of the most dramatic losses absorbed by the PBGC and present considerable funding challenges. However, they have also proved to be valuable to employees and a valuable tool for workforce management in many circumstances.

Congress could consider a proposal that would allow a plan sponsor the option of eliminating these benefits without violating IRC Sec. 411(d)(6). For those employers who wish to retain these benefits, perhaps the following could be considered:

- Retain the ability to provide these benefits if the plan is well enough funded to cover the incremental benefits.
- Treat the shutdown benefits as an ad hoc amendment, similar to an early retirement window, that would phase in PBGC guarantees from the date of the shutdown and trigger the proposed funding requirements. Under this scenario, incremental shutdown benefits would not be payable if the employer could not make the additional contributions required under the proposed rules.
- Increase the variable premium to reflect the liabilities that would be created by these benefits.

Transparency

Disclosure: We agree with the administration's proposal to require more timely and meaningful disclosure of trends in funding ratios, and in fact, would go further. We would require year-end disclosure for all plans. We would also suggest requiring a breakdown of plan assets by equities, bonds (long, medium, short, and government vs. corporate), and other assets to help participants project funding ratios from the most recent information. This is already required on an aggregated-plan basis for financial statement disclosure, so this should not require much additional effort for plan sponsors. However, we would not require disclosure of the at-risk liability for plans of healthy sponsors, since it would not be relevant and could mislead participants.

Earlier Schedule B actuarial information: The administration's proposal would require the Schedule B earlier for plans with more than 100 participants. As noted above, we would include year-end asset information and estimates of year-end liabilities, since similar calculations are already performed for accounting statements and variable premiums (using estimates for significant events). We would also suggest applying this disclosure rule to all plans, regardless of size, as long as estimates can be used. However, we would not require information on the funding standard account until the final contributions are made, which can be up to 8½ months after the end of the plan year.

PBGC guarantees: We would also suggest simplifying PBGC guarantees (as discussed in the transparency section of our funding reform paper) so that the Employee Retirement Income Security Act (ERISA) Sec. 4011 notice to employees, which discloses benefits that would be lost if their pension plan terminated in distress, is more understandable.

Incentives to Fund; Flexibility

Expanding asset transfer rules: Increasing deductible amounts as provided in the administration proposal will help us have better funded plans after market declines.[8 9] However, it will not work unless employers can access a plan's super surplus (above a high threshold) to use for other purposes, such as other employee benefits. Otherwise, employers will be reluctant to take a chance on contributing additional amounts that may later be inaccessible. While some employee advocates have concerns about this issue, we think it can be constructed in a tight enough way to benefit the employees, while at the same time addressing the concern that the pension plan could be insufficient someday. See the discussion on this in our funding reform paper.

Retain credit balance provisions: The credit balance provisions provide incentives to employers to contribute more in good years. (See the earlier discussion on reducing the cyclical nature of minimum contributions with credit balance.) In addition, plan sponsors who accumulated credit balances in good faith under the current rules with the expectation that they were building a cushion for use in future years should not lose that promise.

The administration's proposal to preclude funding of nonqualified deferred compensation (unless the employee pension plan is similarly funded) is an attempt to encourage sponsors to fund the employee plan. However, we don't think it will work, in part because amounts funded for nonqualified deferred plans are already subject to creditors' claims and would generally be forfeited if the qualified plan fails. A real incentive would be to securitize a mirror nonqualified plan to the extent the employee qualified plan is funded, as discussed in the incentives to fund section of our funding reform paper.

Avoid Moral Hazards

Risk-related premiums: The administration's proposal changed the rules for determining the risk-related premium by requiring the earliest retirement age assumption for weak companies, and by using the same discount rate as for funding. In addition, the full funding limit (FFL) exemption is gone, so employers will not be able to avoid paying a variable premium as in the past—unless they are 100 percent funded.

However, we are concerned that the administration's proposal lets the PBGC board set the premium rate and funding policy without limits, and without any input from its premium payers. For example, the PBGC board could decide to set the premium at an amount that would require the remaining DB plans to quickly pay for all of the PBGC's past underfunding. This would require a premium that is greater than is actuarially required from the remaining plans that have not abused the PBGC. Since Congress has never clearly stated whether the PBGC should be funded like an insurance company, a pension plan, or a pay-as-you-go government agency, this rule puts that decision in the hands of the Board without any input from Congress. At a minimum, Congress should set limits on how large the premium increases can be and how well PBGC should be funded. In addition, we note that it is better for Congress to tighten the funding rules than for the PBGC to increase premiums.

PBGC could avoid some distress terminations: The administration's proposal freezes benefits and PBGC guarantees when employers enter bankruptcy. With these powers, the PBGC's losses are limited. We suggest, therefore, that the PBGC could be given the authority to work out pension financing deals with employers, without having to threaten plan termination—its only recourse under current law. This will be especially important if PBGC cannot get (1) higher priority in bankruptcy for its missed contribution claims or (2) the ability to perfect its liens against companies in bankruptcy.

Simplicity

Yield curve: The administration's proposal generally provides simpler rules. One exception is their requirement to use a corporate bond yield curve. While we appreciate the theoretical value of using a yield curve and could adjust our models to incorporate this, a cost-benefit analysis will show that, in practice, the yield curve complicates valuation and lump-sum calculations without adding meaningful accuracy.

For example, using a yield curve will not change the liability, except on a very mature plan during the few times when the yield curve is steep. And it will change the liability by only a small amount (e.g., 3 percent, which would only increase liabilities from $10 million to $10.3 million). At the same time it will decrease the liability for a very young plan, so it may not increase the PBGC's variable premium income by much at all. Furthermore, requiring more accuracy for the discount rate, while prohibiting more accuracy on the mortality table, is not consistent. It is interesting to note that using collar mortality differentials would be enough to undo the small differences created by using yield curves. Thus, Congress should give regulators the ability to simplify the yield curve calculations, if they find it less valuable than initially thought. Note that the PBGC itself originally used a yield curve for multi-employer calculations, but replaced it with the simplified method they use for single employer plans.

Furthermore, the yield curve won't work for the portion of a plan's assets invested in Treasury bonds. Recent experience has shown that Treasury bond prices can increase when corporate bond prices decrease, and vice versa.

In addition, although the proposal phases in the financial effect of the yield curve over a 3-year period, it requires that actuarial valuation systems be revised to accommodate these calculations in time for the 2006 valuation. We suggest that, at a minimum, a simplified yield curve be adopted, something similar to the interest rate structure used by the PBGC. This part of the proposed changes should be delayed to allow for the required reprogramming.

Transition

Three-year transition: The administration's proposal has a 3-year transition period, which may not be sufficient time for contribution volatility concerns, especially if the credit balance provision is eliminated. In addition, if the administration's proposal is adopted without modification, financial observers suggest the need for a longer transition to allow financial markets to adapt to a potential shift in pension asset allocations between stocks and bonds. The bond market, in particular, will need more time for issuers to supply pension plans with the long-dated instruments needed to better match assets to liabilities, without driving interest rates down and exacerbating the problem. A longer transition would be less disruptive. Our anti-volatility mechanism (AVM) could also assist in providing a better transition.

Encourage DB Plans

We applaud the administration's proposal for clarifying the age discrimination and whipsaw issues for hybrid plans. However, the administration's proposal also reaffirms its earlier savings account ideas, requires a 5-year maintenance rule for DB plans converting to cash balance plans, and doesn't resolve retroactivity concerns for prior conversions. These three concerns could cause the widespread elimination of all DB plans by further making it easier to sponsor a defined contribution plan than a DB plan. By continuing to propose changes that undermine the formation and maintenance of traditional DB plans the administration's proposal could seriously harm DB plans, even though DB plans provide vast financial value and benefits to individuals, employers, the markets, and the Nation. We suggest that DB plans need equal treatment with 401(k) arrangements.

At one time policy favored DB plans because (1) they were more likely to provide a lifetime income and (2) they cover almost all employees. With lower tax rates for capital gains and stock dividends, the equilibrium for deciding whether to sponsor a DB or DC plan with all its associated coverage requirements and complex rules, versus just providing cash to employees, has been greatly harmed. We recommend that Congress return its historic tax advantage to retirement plans by taxing pension distributions at the same rates.

Summary

The administration proposes many valuable changes. For Congress to strengthen national retirement security, they must provide an environment that encourages employers to keep their DB plans and pay premiums to PBGC. At a minimum, reform should include:

- controlling the volatility of contributions (by, for example, using the anti-volatility mechanism);
- retaining the credit balance concept (with modifications) to reduce the cyclical nature of minimum contributions and provide incentives for employers to make contributions in good years; and
- allowing employers to access super surpluses for other uses, such as other employee benefits, as an incentive for employers to contribute more in good years.

At the American Academy of Actuaries, we are dedicated to applying our understanding of DB plans to working with the administration and Congress to shape a strong system of financial security for our Nation's retirees.

References

[1] This paper can be found at http://www.actuary.org/pdf/pension/funding—single.pdf.

[2] The administration's use of one funding rule eliminates the DRC funding cliff, which is good, but it would increase volatility anyway due to requiring the use of market assets and only 90-day averaging of market interest rates. For example, equities declined by 33 percent in October of 1987. That could have doubled an employer's minimum contribution. In addition, if only 90-day averaging were in use in 1982 and 1986, the interest rate would have decreased by about 300 basis points in those 2 years, which could have more than doubled an employer's minimum contribution. Some employers might decide to move more of their plan assets into bonds (to dampen the volatility of the plan's underfunding and thus the minimum contribution). However, surveys suggest that many employers have concerns that their contributions would increase too much due to lower expected returns on bonds, and

that their employees would rather take their chances investing in the stock market in a defined contribution (DC) plan. Another option would be for employers to fund their plan more to create a funding margin (which could help employers avoid volatile minimum contributions), but this may not be widely adopted unless Congress relaxes the rules regarding access to surplus assets.

[3] The PBGC could lose their healthy premium payers, but not the weak employers with underfunded plans, because the latter would not be able to fund enough to unilaterally terminate the plan under applicable rules. In addition, under the administration's funding proposal, weak employers may still invest large percentages in equities but not build up funding margins to protect the plan from equity declines.

[4] They also add a loading factor to reflect the cost of purchasing a group annuity, even where a significant portion of the liability may reflect lump-sum payments.

[5] Liabilities a year later could be determined by adjustments for the accrual of benefits, the passage of time, and changes in interest rates and significant events, as is done when utilizing the alternative method for determining PBGC variable premiums.

[6] Smoothing interest rates over 2 years may not be adequate. For example, in 1986, a 2-year weighted average of interest rates would have been just as volatile as the market interest rates, and the 1-year average would have been more volatile (i.e., the 1-year average changed by 350 basis points from January 1986 to January 1987).

[7] The administration proposal requires actuaries to certify that the funded status of a plan exceeds a certain threshold within three months after the beginning of the plan year, in order to stop an accrual freeze. Typically the actuarial valuation is not complete by then, nor does the actuary have the data. If actual data later shows the plan is even more poorly funded, the retroactive effects on participants could be a cause for concern.

[8] In 2002, many plans could not deduct their unfunded ABO at year-end, even though they wanted to. The administration's proposal can be very helpful here.

[9] The administration might consider increasing the maximum deduction to 150 percent of their target liabilities (which are based on corporate bond rates), since the current rules allow deductions using 90 percent of Treasury rates. However, this idea would have to be balanced with revenue concerns. We also suggest that the administration consider repealing the combined plan limit. At a minimum, it should use 130 percent (or 150 percent) of liabilities to conform with the administration's revised rule for DB plans, and it should eliminate the excise tax for non-deductible contributions, since the reversion excise tax is sufficient for employers to not make excess contributions. See these and other ideas in our paper on maximum contributions found at http://www.actuary.org/pdf/pension/deduct—letter—051404.pdf.

Senator DEWINE. Mr. Reuther?

Mr. REUTHER. Thank you, Mr. Chairman. The UAW appreciates the opportunity to testify before this subcommittee on PBGC reform and pension funding issues.

We strongly urge Congress to consider these issues together in a deliberative manner so it can formulate policies that truly benefit workers and retirees, employers, the PBGC, and the entire defined benefit pension system. These pension policies should not be dictated by arbitrary deficit reduction targets.

In particular, the UAW urges the HELP Committee to insist on the provisions in the Senate's budget resolution relating to the PBGC and to oppose the counterproductive House provisions that would require the committee to produce much higher savings attributable to the PBGC. In our judgment, the dangerous House budget provisions could preclude the adoption of sound policies to improve pension plan funding and could force the adoption of extreme PBGC pension increases that would drive many employers to exit the defined benefit pension system.

It is important to recognize at the outset that there is no immediate crisis at the PBGC. As the administration has admitted, the PBGC has sufficient assets to pay all guaranteed benefits for many years to come. There also is general agreement that the PBGC's

projected deficit is directly attributable to the widespread bankruptcies in the steel and airline industries.

The UAW strongly opposes the administration's proposals relating to the PBGC that would cut the guarantees provided to workers and retirees and place strict, arbitrary limits on benefits provided by pension plans, sharply increase the flat and variable premiums paid by employers, and link the variable premium to the credit rating of a company, and give the PBGC a lien in bankruptcy proceedings for any unpaid pension contributions.

The cuts in PBGC guarantees and pension benefits would unfairly punish tens of thousands of workers and retirees, reducing the adequacy of their retirement benefits and having a discriminatory impact on blue-collar workers.

The premium increases would impose a significant economic burden on many companies and could trigger an exodus of employers from the defined benefit pension system.

The bankruptcy lien would punish troubled companies and their retirees and lead to more liquidations, lost jobs, and lost retiree health benefits, as well as more pension plan terminations and even greater liabilities being transferred to the PBGC.

Instead of these harmful counterproductive proposals, the UAW believes the PBGC can be strengthened through a number of approaches. First, the UAW believes the overall funding of pension plans can be improved through the series of balanced reforms described in section three of our testimony. By taking these steps now to improve the funding of pension plans, Congress can improve the security of benefits to workers and retirees and also reduce the long-term exposure of the PBGC.

The UAW opposes the funding proposals advanced by the administration. They would result in highly volatile funding requirements, making it more difficult for companies to plan their cash flow and liability projections. In addition, these proposals would impose significant economic burdens on many employers, punishing companies that are already experiencing economic difficulties. The proposals also would discourage companies from contributing more than the bare minimum during good economic times and instead impose sharply higher countercyclical funding requirements during economic downturns.

Second, the UAW supports the enactment of a new plan reorganization process in situations where the employer has filed for Chapter 11 bankruptcy. We believe this type of 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 preventing unfunded pension liabilities from being transferred to the PBGC. This approach would be beneficial for workers, for retirees, for companies, and for the PBGC.

Third, the UAW believes that resolving the legal uncertainties surrounding cash balance plans could encourage more employers to remain in the defined benefit pension system to the benefit of the PBGC as well as workers and retirees.

Fourth, the UAW believes the best way to deal with the steel and airline liabilities that have or will be assumed by the PBGC is to have the Federal Government finance these liabilities over a 30-

year period. This would be far less costly than the administration proposal to increase significantly the amounts that could be contributed to individual retirement and savings accounts. In our judgment, this approach would be far better for workers and retirees, for employers, for the PBGC and the entire defined benefit pension system.

In conclusion, the UAW looks forward to working with the members of this subcommittee as you consider these important issues. Thank you.

Senator DEWINE. Mr. Reuther, thank you very much.

[The prepared statement of Mr. Reuther follows:]

PREPARED STATEMENT OF ALAN REUTHER

SUMMARY

The UAW believes Congress should adopt balanced proposals to strengthen the PBGC and the security of pension benefits for workers and retirees, to improve the funding of pension plans, and to encourage employers to remain in the defined benefit pension system. Congress should consider the PBGC and pension funding issues together in a deliberative manner that will enable it to formulate policies that truly benefit workers, retirees and employers, as well as the PBGC and the entire defined benefit pension system. Pension policy should not be dictated by arbitrary deficit reduction targets.

There is no "crisis" at the PBGC. It has sufficient assets to pay all guaranteed benefits for many years to come. The PBGC's growing deficit is directly attributable to the widespread bankruptcies in the steel and airline industries.

The UAW strongly opposes the administration's proposals to cut the PBGC guarantees and pension benefits for workers and retirees. These changes would unfairly punish tens of thousands of workers and retirees. We also oppose the administration's proposals to drastically increase the flat and variable premiums paid by employers to the PBGC. This would impose a significant economic burden on employers, and could encourage an exodus of employers from the defined benefit pension system. Finally, 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.

The UAW believes 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 specified in Section III of this testimony. Second, the plan reorganization process described in Section II of this testimony would help to reduce the number of bankruptcy cases that result in pension plan terminations and liabilities being transferred to the PBGC, by providing greater flexibility to adjust funding and benefit obligations. Third, resolving the legal uncertainties surrounding cash balance plans could encourage more employers to remain in the defined benefit pension system. Fourth, 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 30-year period.

INTRODUCTION

The UAW appreciates the opportunity to testify before the Subcommittee on Retirement Security and Aging of the Senate Committee on Health, Education, Labor, and Pensions on the subject of: "PBGC Reform: Mending the Pension Safety Net." We look forward to working with the subcommittee as it considers the important issues relating to the Pension Benefit Guarantee Corporation (PBGC) and the funding of single-employer defined benefit pension plans (hereafter referred to as "pension plans").

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 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 should adopt balanced proposals that will bolster the PBGC and the security of pension benefits for workers and retirees. We also support measures to strengthen the funding of pension plans and encourage employers to continue these plans.

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, plant 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 subcommittee 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 subcommittee to achieve these objectives.

I. RELATIONSHIP TO BUDGET RESOLUTION

The UAW believes it is imperative that Congress consider the PBGC and pension funding issues together in a deliberative manner that will enable it to formulate policies that truly benefit workers, retirees, and employers, as well as the PBGC and the entire defined benefit pension system. Pension policy should not be dictated by the need to fill a budget hole or arbitrary deficit reduction targets.

Although increases in the PBGC premium are scored as a "savings" for budget purposes, the truth is they are a tax on employers that sponsor pension plans. We believe Congress should consider the impact of such increases on companies and the pension system generally, and not simply view this as a "cash cow" to reduce the deficit.

The UAW is particularly concerned about reports that the budget resolution conference report may require the Health, Education, Labor and Pensions Committee to produce much higher "savings" attributable to the PBGC than was originally proposed in the budget resolution passed by the Senate. This in turn could preclude the adoption of sound policies that would improve pension plan funding and reduce plan terminations, but might also reduce general revenues. In addition, it could force the adoption of extreme premium increase proposals—such as those proposed by the administration—that would impose a 60 percent increase in the flat rate premium and enormous increases in variable rate premiums levied on employers. The UAW submits that premium increases of this magnitude will drive many employers to exit the defined benefit system, thereby undermining retirement security for millions of workers and retirees and ultimately weakening the PBGC.

For these reasons, the UAW strongly urges the HELP Committee to insist on the provisions in the Senate's budget resolution relating to the PBGC, and to oppose the counterproductive House provisions.

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 attributable 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 judg-

ment, 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. Limits on PBGC Guarantees and Pension Benefits

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 5-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.

The UAW also 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, regardless of how well funded they may be.

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. In addition, it is unfair to outlaw plant closing benefits that primarily benefit blue collar workers, while still allowing golden parachutes for top management.

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 5-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 plan reorganization process proposed by the UAW in Section II D 2 of this testimony would provide greater flexibility to adjust benefits and funding obligations in situations where an employer has filed for Chapter 11 bankruptcy. This would enable more employers in Chapter 11 cases to continue their pension plans, while protecting workers and retirees to the maximum extent possible. In our judgment, this flexible approach is far better than the arbitrary, one-size-fits-all benefit limits suggested by the administration.

B. 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 who sponsor plans that are less than fully funded, and to have the amount of this 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.

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 PBGC

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.

1. Improve Pension Funding

First, the UAW believes that the overall funding of pension plans can be strengthened through the reforms described in Section III 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.

2. Plan Reorganization Process

Second, 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 30-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.

3. Cash Balance Plans

Third, 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 rea-

sonable 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.

4. Steel and Airline Pension Liabilities

Fourth, 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 30 year period. This could be accomplished by having the Federal Government (or the PBGC) issue 30-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 10 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 30 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 has 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.

III. 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 HELP Committee 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 HELP Committee 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 HELP Committee 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 HELP Committee 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 and Use of Excess Pension Assets

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 HELP Committee 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.

CONCLUSION

The UAW appreciates this opportunity to testify before this subcommittee on Retirement Security and Aging to express our views on the subject of: "PBGC Reform: Mending the Pension Safety Net." We urge Congress 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 subcommittee as you consider these important pension issues. Thank you.

Senator DEWINE. Mr. MacFarlane, can you summarize simply the primary reasons that British firms have recently frozen an estimated 60 percent to 70 percent of defined benefit plans? And then after you finish, I wonder if, Ms. Bailey, if you have any thoughts on this. I know Timken has some familiarity with this because you are in the UK.

Mr. MACFARLANE. The first is cost. The second is investment performance. The investment performance, I think, is particularly related to the United Kingdom, where the industry default benchmark which is used by most schemes was not a specific benchmark related to liabilities of that particular fund, but rather an industry default, and what that meant over a 30-year period was that the ratio of equities in the overall asset mix drifted up, and as it drifted up, of course, that was fine through the 1990s, but from 2000 to 2003 in particular, as the equity markets rolled over, that really hurt investment performance.

The other issue was the fact that interest rates were falling steadily, and as interest rates fall steadily, the actuarial liability of current liabilities rises.

And last but not least, the point which I was pushing a lot was FRS 17 and the volatility which that imparts in balance sheets. At a minimum, what it does is it adds administrative burden, worse because it is a snapshot approach. It creates a considerable amount of volatility and, therefore, companies would rather do without that particular burden.

Senator DEWINE. Ms. Bailey?

Ms. BAILEY. Yes, thank you, Mr. Chairman. The only addition I would make to Mr. MacFarlane's statements is that liquidity in the UK fixed-income market is very different than the liquidity in the U.S. fixed-income market, and what has happened is as UK pension plans had to look to put more into fixed income, there were fewer bonds, whether they were government treasuries or whether they were corporate bonds, fewer bonds to invest in, which may

likely have been part of what was bringing down the interest rates during that same time period.

Senator DEWINE. Mr. Reuther, I wonder if you could give us your opinion about why there are so many employers that seem to be walking away from their defined benefit pension plans.

Mr. REUTHER. Well, I think there are various factors. Some of it has to do with cost and looking at the nature of the workforce. That is why we think it is so important that the changes in the funding rules and the premiums not be counterproductive and not, in effect, send a signal to employers that your costs are going to become unpredictable or that they are going to go through the roof if you decide to stay in the defined benefit pension system.

Senator DEWINE. Senator Mikulski?

Senator MIKULSKI. Mr. Chairman, this is indeed a very content-rich panel. But what strikes me is both the UAW and Ms. Bailey and the business groups seem to be in alignment with the yellow flashing lights about the President's proposal, and it goes to some of the questions I have about often the unintended consequences of reform.

Defined benefits seem to be primarily in mature industries, probably primarily in manufacturing or farm equipment or many things like that. And they are often unionized.

My question would be, what would be the consequences of increased premiums? Will they pull out of their plan? Will troubled industries, maybe that are just trying to even dig out, then even be more exacerbated because they have to put money into the pension guarantee when they need to put money into digging out or their own plant or their health plan? We are not only talking about this.

Ms. Bailey and Mr. Reuther, how do you see this, and what would be the answer, because I don't think we can have one-size-fits-all reform. How do you reward the good guys that are stable and so on, the good guy corporations? No. 2, if you weren't troubled, what should be the role, therefore, of government—of the pensions' involvement with you, not to exacerbate the problem, but not to leave the taxpayer with an increasingly growing unfunded liability? Can you help me out with this?

Ms. Bailey, do you want to start, and then Mr. Reuther?

Ms. BAILEY. Certainly. I would start with saying that I think we need full debate on this issue and we need targeted reform and we need time to get through the complexity of the issues that we have talked about today. So I think it would be a disservice to the groups that I represent as well as a disservice to the committee to go forward with some simplistic answer to this question. We need to be able to look at it in the broad nomenclature of pension reform.

But that having been said, if we look specifically at this premium issue, what we have to remember is those premiums are not paid by the companies. Those premiums are paid by the plan assets. And so——

Senator MIKULSKI. They are paid by what?

Ms. BAILEY. They are paid by the trust. So, in other words, the premiums don't specifically come from the Timken Company. In our case, the Timken Company would pay the premiums to our

trust, which holds the assets associated with the pension plan, and then the pension plan would pay the premiums to the PBGC. So there is an intermediary. It doesn't go directly from the Timken Company to the PBGC.

But more importantly, or in addition to that, what we need to remember is that we are looking at very high increases in the current budget reform related to PBGC premiums, and by——

Senator MIKULSKI. You mean the 19 to 30 flat——

Ms. BAILEY. Yes.

Senator MIKULSKI. Yes.

Ms. BAILEY. Along with the way the variable—there is uncertainty as to how the variable premiums would actually even be calculated. So we don't know today how the variable premiums would be calculated, and what that will do is take funds away that could be contributed to the pension plan, and rather than going in as a contribution to the pension plan, those same funds could go as contributions to, in a sense, to fund the PBGC's deficit versus contributions to improve the funding status of an individual pension plan.

Senator MIKULSKI. So you believe, number one, full debate.

Ms. BAILEY. Yes.

Senator MIKULSKI. No. 2, that one size doesn't fit all. And number three, this new increase in the, I will call it the flat fee, could also have consequences yet to be determined.

Mr. Reuther, and then Mr. Gebhardtsbauer?

Mr. REUTHER. We very much agree that the premium increase proposals will send a powerful signal to employers to exit the defined benefit system, both the magnitude of the premium increases and also the variable premium being tied to the credit rating of a company. We think you will see companies freezing their plans or terminating them to the detriment both of the PBGC, because that will further narrow the premium base, and also to the detriment of the workers and retirees.

The impact on companies is compounded when you add in the administration's funding proposals, which are both volatile, don't give credit to companies when they contribute more than the bare minimum——

Senator MIKULSKI. Let me jump in here. As you know, Toyota is really rapidly pushing ahead. General Motors has got some rocky times here. Ford has had rocky times. Have they told you what the consequences of these would be, or is that an inappropriate question to ask you?

Mr. REUTHER. We obviously are in discussion with the auto companies——

Senator MIKULSKI. When I say inappropriate, sometimes that is labor negotiations are more privileged than to be discussed in an open hearing.

Mr. REUTHER. We are in discussions with the auto companies and other major employers that we have collective bargaining agreements with and the uniform reaction is very negative to these proposals, both the premium proposals and the funding proposals. In effect, what is happening is you are asking other employers that sponsor defined benefit pension plans to assume the burden of paying for the steel and airline liabilities that have been transferred

to the PBGC, and I would just submit that in the end, that is going to be counterproductive, that that will drive employers away from the defined benefit system, which is what we don't want.

Senator MIKULSKI. Thank you, Mr. Reuther.

Mr. Chairman, Senator Enzi, I went to an incredible party on the weekend. My General Motors plant closes on May 13. It was the— it made the mini-van. We had 20 good years. They actually opened the plant in 1935, during the depression, the same year my father opened his little grocery store. So we have been kind of living together.

The workers, most of the workers at this plant were eligible for retirement because we had Allison Transmission, where the younger workers went. But there was a feeling—no one was jittery. No one was boiling mad. And when I circulated among many of the workers who were either retirees or about to be retirees, it had a sense of security. Did they think it was going to be like the good times, like the old times? No. But did they have a sense of security? And that had made all of the difference.

I am just really scared about what is happening here, because when you look at those men and women, and I just only use that as an example, but it is the sense of security that has enabled them to be productive workers, come to an end. There is an inevitable end at this factory, sad but inevitable, and we accepted it.

And we really, I tell you, we have to really put our shoulder to the wheel, but my eyes are glazing over here. This is pretty complicated. They are not glazing over. I mean, I feel like I need five pairs of glasses and 20 assistants and going to the London School of Economics.

[Laughter.]

But I think other than that, I am ready to go. But I do think that this is what it is all for. I don't know if you all are experiencing the same thing. Thank you.

Mr. GEBHARDTSBAUER. I would be glad to stop by and help out. I am an actuary, and I have got those five glasses, so—

[Laughter.]

Senator MIKULSKI. OK.

Mr. GEBHARDTSBAUER. We had something, in fact, in our paper on just how to fix some of these funding rules. We like a lot of the stuff that is in the proposal from the administration, but there were some concerns that we had and one is we would encourage, and, in fact, require companies to put more money in in the good years. That would answer your concern about having them put a lot in in the years when they are weak. Put it in earlier when the employers are doing well.

And right now, actually, the rules do require companies with pension plans for salaried employees to put money into the pension plan even when they are more than 100 percent funded. The administration proposal actually stops at 100 percent and says, once you are 100 percent funded, you don't have to put any more in. And so good companies are hoping we will put more money in, but our concern is weak employers won't.

So what we would encourage is more companies to put more money in when the company is strong. In addition, to encourage more money going into the pension plan, the credit balance does

that. In addition, the administration also would allow you to put more money in. They don't require it, but they would allow you to put more money in. We think that is a great idea except that a lot of employers won't do that.

Back before I was the Chief Actuary of the PBGC, I was a pension consultant, and I would give my clients three numbers. Here is the minimum you have to put in under the law. Here is the maximum the law will allow a deduction. But here is my recommended contribution. Employers would put the recommended in. But then after a certain law was passed, now all they do is just put in the minimum, only what is required.

And that law that is talked about is—I think it is going to be a tough one to look at, but I think we can get something so that both employers and employees would feel okay with this idea, and what it is, it is the idea that if you have a super-surplus in your pension plan, in other words, if you have lots of money in your pension plan, you have contributed a lot, you are up at 150 percent, and then the stock market does well, now you have a 200 percent funded pension plan. You can't get an economic value from that.

And some people are talking, even people who represent employers have talked about the possibility if you are way overfunded, being able to move some of that money into the, say, the employee health plan so that the employee health plan is continued. And at one time back in the 1990s, there was a debate on this and the debate didn't go well and it didn't pass, and I know the Academy was very concerned about some of the provisions in the bill in the 1990s because it would actually let you take money out when the pension plan was underfunded.

But if you put a good threshold on it and say you can't take money out when it is below this, then employers are more likely to want to pay the recommended contribution, put more into the pension plan in the good years so that in bad years or after stock markets go down, there will still be a solvent pension plan. Thank you.

Senator DEWINE. Senator Isakson?

Senator ISAKSON. Thank you, Mr. Chairman.

Ms. Bailey, on that line of conversation, in your printed testimony, you had some comments on eliminating prefunding barriers. Would you elaborate a little bit on that?

Ms. BAILEY. I am sorry, Senator, could you point me to which part of the testimony you are referring to?

Senator ISAKSON. Page 10 of your testimony, eliminating prefunding barriers, tax deductibility——

Ms. BAILEY. Yes, absolutely. Thank you very much. Right on with that, I guess two points. One is that during good times, companies should be able to put in—I think we are looking at 150 percent——

Senator ISAKSON. Right.

Ms. BAILEY. [continuing]. Trying to ask the current law to be increased to 150 percent so that we can get full tax deductibility, and right now, there is a limit in terms of what the funding is and how much—I am sorry, there is a confusion between—there is a limit on how much of a pension contribution can actually be tax deductible, and so clearly, an employer has no incentive to put money in

that is going to be greater than the amount that is tax deductible for that current year.

And so what we are asking is that employers have the opportunity to put funds in—to increase the tax deductibility of pension contributions so that during the good times, we have another incentive to put more funds in and improve the funding of the plan.

Another point I would like to make, if I might, is that it is always in an employer's best interest from a financial statement—particularly a publicly-traded company—from a financial statement point of view to have a fully-funded pension plan, because pension expense—part of pension expense is the normal service costs, but part of the pension expense which shows up on employers' financial statements are the interest costs associated with the liability for the unfunded part of the plan, and if you go and look at some of your constituency organizations, you will see that their earnings are depressed by the amount of the pension expense associated with that liability.

So it is always in an employer's best interest, from not only providing retirement security to our associates, but it is in our best interests in terms of how we deal with capital markets to have a fully-funded plan, and so I think, again, what I would ask the committee to do is look for reforms which will help us in all parts of the variety of complexity we are looking at to make things simple and transparent, but let us look at the entire part of it together and give employers an opportunity to, in good times, contribute more to pension plans.

Senator ISAKSON. I take it, Mr. Gebhardtsbauer, that you would agree with her comments in terms of lowering those barriers to prefunding and the comment on tax, as well?

Mr. GEBHARDTSBAUER. Right. Yes, we would agree. In fact, the administration proposal even does allow you to put money into the pension plan until your assets get up to 130 percent funding, and I think Ms. Bailey was talking about 150 percent, and there are good reasons for that, because right now, the calculations are done at Treasury rates and now it is going to be corporate bond rates, so 150 percent using corporate bonds makes sense.

In fact, in addition to what she mentioned that you can't get it fully deductible, you can also possibly have an excise tax because you have put more money in the plan. So it was a good thing, but we are going to excise tax you.

Senator ISAKSON. Right.

Mr. GEBHARDTSBAUER. And then the other problem is the administration has gone to a certain point saying, yes, you can put the money in, but if the stock market does really well, you can't use that money, and there are pension plans out there that are still 200 percent funded and they can't do anything with that surplus money in the pension plan.

So I think even the UAW has talked about this idea of allowing employers, when you have a really well-funded plan, take some of the excess out and put it in the employee health plan. A lot of employers are talking about cutting back on their employee health plans. If there was excess money in the pension plan, then that could be used, and then you would be willing to put more money

in the pension plan if you knew you could use it for some of these other reasons.

Senator ISAKSON. Mr. Reuther, I think your comment with regard to steel and aviation favored a 30-year amortization, is that what you said?

Mr. REUTHER. That is correct.

Senator ISAKSON. Specific to those two industries?

Mr. REUTHER. To the liabilities that have been transferred to the PBGC from those industries, yes.

Senator ISAKSON. Not to pick on you, Mr. Gebhardtsbauer, but do you agree with that?

Mr. GEBHARDTSBAUER. Yes. In fact, in our proposal, we suggested that right now—in fact, it was at the beginning, the first paragraph—right now, all the PBGC can do, for instance, with United Airlines was to terminate it. But if they had the ability to freeze benefits, then their liabilities aren't going to go up anymore. They are not at risk of having this unreasonable increase in liabilities. So at that point, maybe they could work out a deal with the airlines.

I am not saying that all airlines and steel plants should get it automatically. I think it is something that the PBGC should be able to go into negotiations with certain companies and deal with the particular situation they have. I think even a former Executive Director of the PBGC and I think someone from Northwest Airlines suggested this in a Wall Street Journal article, that if you can freeze benefits, then the PBGC should be able to work out a financing deal. They may not go all the way to 30 years. PBGC may not want it to go all the way. But maybe give them a break. If you are going to freeze your benefits, maybe we can give you a break on funding for a short period during the tough times.

Senator ISAKSON. And that is far superior to just having to assume the liability of the pension fund.

Mr. GEBHARDTSBAUER. Right. PBGC in September had $23 billion in its deficit, its underfunding, and almost all of that was probable. Now it is pretty much—they are all starting to take a lot of that over. They have taken over U.S. Airways, United. It would be great if they had something besides the atomic bomb, you know, we are going to take you over. That is the only power they have right now.

Senator ISAKSON. Thank you.

Mr. GEBHARDTSBAUER. They need some regulatory authority.

Senator ISAKSON. Thank you, Mr. Chairman.

Senator DEWINE. Senator Enzi?

The CHAIRMAN. Thank you. This has been an extremely educational morning and extremely helpful morning. Right now, the negotiations are going on on the budget regarding the Pension Benefit Guaranty numbers, and what we have been shooting for on the Senate side is some flexibility so that we could actually solve the problem instead of just raising rates, which makes great window dressing but it doesn't solve the problem.

So I really appreciate having all of you on the panel. I really appreciate the additional information that you gave us in the lengthier testimony. There are a lot of ideas there that I think can lead us to a solution that will work with as little pain as possible.

There is some pain involved in it no matter how we do it at this point, but I can't tell you how happy I am that you have served on the panel.

You realize that gives us the right to ask you questions in writing, which we can only ask you to answer, but we can get considerably more detailed in some of those answers and it also keeps the audience from going to sleep. I have some of those, particularly for Mr. Gebhardtsbauer, because in my State legislative career as well as here, I have placed a lot of credibility in an outside actuary taking a look at what is being asked. I have never been disappointed.

Since I got here, we had a little railroad issue, and it was having some serious consequences. Several times, they asked me if I would vote for the bill and I said, well, I need to see an outside actuary. Get me some information. How much is this going to hurt? Will it hurt? Will it help? After about their third visit to me, they brought an outside actuary report and I got to visit with them a little bit too, and it confirmed that the plan would be better if we made the changes. So I was one of the few Republicans that voted for the railroad change, and I am very relieved at how it has come out.

But I do appreciate all the testimony. Mr. Gebhardtsbauer, there is much being made about plan sponsors, about the need for predictability and the problems of volatility. Do you feel there is a greater need for smoothing of asset values and liabilities, and if so, is there a consensus in the actuarial community about how these should be smoothed and whether it should be done at the front end or the back end? I think that has to do with your chart.

Mr. GEBHARDTSBAUER. Great question. Actually, actuaries, as in your experiences in the past, we are more like advisors. We don't say exactly how you should do it, and in particular at the Academy, we don't take positions that endorse particular legislation, and so we have actually talked about three ways of doing something.

One way would be to smooth the assets and the liabilities, sort of at the front end of the calculation, or you could smooth the funding ratios. You could look at the funding ratio this year and last year and smooth them. Or you could smooth the contribution. Another way of talking about that is actually not smoothing the contribution, but, in fact, by the way, back to that chart, I apologize to Senator Mikulski and you all. I got a copy now of what you have, and this is my simpler chart, which is two lines. That is the one you have. And so the green line up here is actually a purple line on yours and that actually gets into answering your question.

When we did this calculation, we smoothed the contribution, but you can also do it through smoothing assets and liabilities or through smoothing the funding ratios. But by smoothing it, you will notice the contribution went gradually down. That red line went gradually down instead of all of a sudden going to zero, as in the administration proposal. So, in fact, what that meant was in the good years, the employers actually had to put more money into their pension plans, so the pension plans were actually better funded.

So the reason why I am bringing that up is that you can have smoothing and have better solvent plans than even in the administration proposal. So you can have both. You don't have to sacrifice one for the other. I know a lot of people talk about if you are for

smoothing, that means you are against solvency, but that doesn't have to be the case. You can want solvent, 100 percent funded plans and have smoothed contributions.

The CHAIRMAN. Thank you. I will have a lot more questions for all of you. I really appreciate it.

Senator MIKULSKI. Mr. Chairman, I want to really think about what we heard here today. I think it was an excellent primer on the issues, the challenges, and a variety of solutions and look forward to working with you in additional hearings and really solving—dealing with this in a way that does not exacerbate the problem.

Senator DEWINE. I want to thank our panelists. You have got us off to a very good start. You have been very informative, very, very helpful, and we look forward to working with all of you.

As Senator Enzi said, you can anticipate some written questions, so we appreciate it. Thank you all very much.

[Additional material follows.]

ADDITIONAL MATERIAL

PREPARED STATEMENT OF SENATOR KENNEDY

Defined benefit plans are a critical part of our retirement system, covering over 40 million workers, retirees and their families. All of us agree we need to strengthen our defined benefit system. We need to find ways to expand coverage of workers and encourage employers to start new defined benefit plans. And we must require companies to adequately fund their pension plans. At the same time we must not take extreme measures that would drive companies out of the system. The number of defined benefit plans is already on the decline—we cannot afford to hasten this trend.

The administration has suggested a proposal to revise funding rules which companies have been using for years, and in most cases, decades. While I agree that we must protect pensions that workers have earned, I am concerned that the President's proposal would have the opposite effect. Indeed, it would cut benefits that workers have been promised. And penalizing companies that offer pensions by drastically increasing the cost of those pensions will hurt workers and retirees, as well as jeopardizing the long-term stability of the Pension Benefit Guaranty Corporation (PBGC).

One of my chief concerns is the administration's approach to workers' benefits. This proposal would make workers pay the price when companies falter, effectively giving companies a permission slip to break their pension promises to workers. It would take away benefits increases that workers have been promised. And when companies get in trouble, it would freeze workers' benefits as well as the pensions they are guaranteed by the PBGC. Such changes would unfairly punish workers and retirees.

The proposal would also prohibit companies from offering shutdown benefits. These benefits have been vital to workers and their families in sectors like our steel industry, which has faced intense international competition in recent years. Tens of thousands of steel retirees who have seen their plants close and their jobs eliminated now rely on these benefits to support themselves and their families. Taking away these benefits will be disastrous for these families and their communities.

We must do more to strengthen companies' promises to workers. But this should be done by requiring companies to pay for what they've promised by contributing more to their pension plans, not by taking away workers' retirement.

The administration argues that the changes it proposes are necessary to protect the PBGC. But we need to remember the PBGC was created to protect workers' pensions, not the other way around. We should also bear this principle in mind when considering the administration's proposal to drastically expand payment of premiums to the PBGC. I commend Chairman Enzi for his efforts to ensure that pension policy will drive our debate, rather than balancing the budget. While I agree that reasonable increases are acceptable, we should not be drastically increasing costs for employers who want to do the right thing by providing these guaranteed benefits to their workers.

Astonishingly, the administration's proposal ignores the greatest threat to the PBGC: the difficulties faced restructuring industries.

Our airline industry has been hit by global terrorism, increased competition, and now record high fuel prices. The PBGC projects that over 90 percent of the underfunding it will assume stems from steel and airline companies; and indeed, just last Friday, the PBGC terminated four pension plans at United Airlines. I am concerned that the agency seems to have no plan to address the very real short-term crisis that could be caused by termination of additional airline pension plans and the loss of benefits by hundreds of thousands of retirees at airline and steel companies.

The PBGC should be focusing on ways to help troubled pension plans before they fail. Currently, the PBGC's only option is termination: this is untenable. A plan termination is a losing situation for all the parties: workers see their benefits cut, and the PBGC assumes more liabilities. We need an approach that gives workers a say in what happens to their pension plans, instead of imposing automatic pension cuts. This would help workers and retirees by preserving at least some of the benefits that would otherwise be lost if the PBGC were to take over their plan. It would help employers to continue to fund their plans; and it would help the PBGC by reducing its exposure to plan losses.

Instead this administration is focusing on long-term changes that do nothing to address these immediate issues and would make pensions much more expensive for companies with older workers and manufacturing companies. The President's proposal would punish companies that are already experiencing economic difficulties, by adopting a Yield Curve of corporate bond rates that would mean increased volatility and complexity that present a huge burden for employers. All of these factors will force many employers to drop their defined benefit pension plans.

This is the wrong direction for us to take. We all agree that changes to our funding rules are needed, but we should be sure that our solutions fit the problems our pension system is confronting. I look forward to working with my colleagues on finding ways to protect and strengthen our defined benefit system.

RESPONSE TO QUESTION OF SENATOR KENNEDY BY RON GEBHARDTSBAUER

AMERICAN ACADEMY OF ACTUARIES,
May 31, 2005.

Hon. TED KENNEDY,
U.S. Senate,
Washington, DC 20510–6300.

DEAR SENATOR KENNEDY: We appreciate the opportunity to respond to your question following the April 26, 2005 hearing of the Subcommittee on Retirement Savings and Aging on PBGC Reform.

Question. The American Academy of Actuaries has proposed a number of solutions to tighten existing pension funding rules. How would these proposals compare with what the Administration is proposing in terms of improving pension funding levels?

Answer. We must note that while we make suggestions on various ways to improve the pension funding rules, we do not offer one particular suggestion. However, we have provided some specific responses to the request below. More details can be found in our 60-page issue analysis, *Pension Funding Reform for Single Employer Plans, and our analysis of the administration's pension funding proposal* (March 2005). In addition to these papers, which apply only to single-employer pension plans, the Academy has presented a separate paper, *Principles of Pension Funding Reform for Multiemployer Plans*, because there are so many differences between single and multiemployer plans.

Targeting a 100 Percent Ceiling Funding Level: The administration provision that improves funding levels the *most* is their requirement that sponsors fund all their plans until they are 100 percent funded for accrued benefits. The current rules were designed around a 90 percent funding target. In addition, the administration proposal requires PBGC variable premiums until the plan is 100 percent funded. That creates an incentive to contribute up to the 100 percent funding level. The Academy also suggested these two ideas. However, the administration target is also a ceiling. As soon as the 100 percent funding level is reached, minimum contributions stop. We would go further, as suggested in the section on funding margins (see below).

At-Risk Liability Target: The administration proposal increases the funding target if the credit rating of the plan sponsor falls below investment grade. However, the additional funding to the administration's "at-risk" liability may happen too late, because a company may already be too weak to make the additional contributions. Thus, it may not have the intended impact. For example, some plans in bankruptcy have not paid their minimum contributions even under the current rules, which don't include the at-risk increase. Some practitioners have suggested that this provision may cause employers of plans that have much larger termination liabilities to seek bankruptcy protection to avoid these larger funding obligations.

The Academy considered suggesting these higher funding targets for all companies, but the additional funds may never be needed and any excess funds cannot be accessed without paying prohibitive taxes of over 90 percent. For example, some companies have been below investment grade for many, many years without going bankrupt, and investment bankers consider it unlikely they ever will, so the higher at-risk calculation using earlier retirement ages would be inaccurate. Another response would be for Congress to consider requiring funding margins for all plans as suggested below.

Speed to Funding Target: The administration would require sponsors to fund a plan's underfunding over 7 years (or possibly 10 years). The Academy has not taken a position on how fast the amortization should be, but has suggested anywhere from 5 years (the current number of years for benefit improvements to be guaranteed by the PBGC phase-in) to 15 years (if the plan doesn't deplete itself with the payment of lump sums). Of course, 5-year amortization would improve funding levels the most, but the trade off would be that contributions would be higher and more volatile.

The administration proposed an amortization rule that some are calling one-sided (or the high-water-mark method), because their amortization payments do not decrease if the plan experiences unusually good asset returns or liability loses. Under this rule, plans would probably reach 100 percent funding sooner than 7 years.

As an alternative, the Academy suggested an *anti-volatility rule* that would keep the contribution from falling or increasing too fast. The attached chart, used for my April 26, 2005 testimony, shows that if the administration proposal had been applied in the economic scenario of the past 10 years, the minimum contribution for the sample plan would have fallen quickly to zero in the late 1990s, and jumped back up in 2002. The anti-volatility rule we suggest would have kept the minimum contribution from falling so fast, so funding ratios would have been higher. In fact, in all economic scenarios we studied, the funding ratios were about as good as or better than the funding ratios produced by the administration proposal. Faster 5-year amortization and our creation of funding margins also play a part in that analysis.

Creating Funding Margins: The minimum required contribution under the administration proposal is *zero* after 100 percent funding is reached. However, due to the increased volatility risk and the penalties for plans being less than 100 percent funded, the administration's proposal may drive sponsors to reduce their risk by building up funding margins and/or allocating more assets to bonds to avoid the penalties for underfunding (e.g., variable premium, quarterly contributions, benefit freezes). This would be a positive outcome for the PBGC. However, we do not think this will be enough motivation for weak employers with poorly funded plans to contribute the large amounts needed to avoid these penalties, or to move to bonds.

The Academy suggests that more than encouragement might be needed for all plans to build up funding margins. Strong companies may build funding margins, but the weak employers will only contribute the minimum required, and their plans are the ones that are more likely to be taken over by the PBGC. Ways to require contributions above 100 percent funding levels would be as follows:

• Require a contribution equal to the cost of current year accruals until some higher threshold is reached, such as 100 percent + X percent of accrued liabilities, 100 percent of accrued liabilities using projected pay (or projected multipliers for hourly plans), or 100 percent of accrued liability including contingent benefits, or

• Phase out the normal contribution more gradually than the dollar-for-dollar phase-out in the administration proposal. For example, the minimum contribution could equal the normal cost plus the surplus divided by a N-year amortization factor. This could be the same factor used in amortizing the deficit for underfunded plans, which would make for a very simple formula.

These rules could be relaxed if the employer increases its allocation to bonds and/or reduces its exposure to subsidized early retirement benefits and subsidized lump sums.

Penalties for Underfunding: The administration increases the incentives for funding by increasing or adding new penalties for underfunding (e.g., no benefit improvements if funded under 80 percent, benefits frozen and lump sums eliminated at 60 percent funding levels). We have made similar suggestions. However, to reduce the possibility of a run-on-the-bank, we suggest a provision that would allow the plan to pay the lump sum only to the extent funded.

For example, if the plan is 90 percent funded, then it could pay 90 percent of the lump sum. Alternatively, the rules could increase the minimum contribution by the underfunded portion of the lump sum. Sponsors also could be encouraged to eliminate their lump-sum provisions and replace them with a 20-year certain life annuity, which would make sure that unhealthy employees would not lose value. We also note that the current rules in the Code of Federal Regulations (CFR) 1.401(a)(4)-5(b)(3) already restrict lump sums for highly compensated employees (HCEs) or the top 25 when funding ratios are less than 110 percent. They could be applied to all HCEs.

The penalties are also more volatile under the administration proposal, because they use market assets and market liabilities. Some sponsors might avoid them by increasing funding levels or investing more pension assets in bonds, as suggested above.

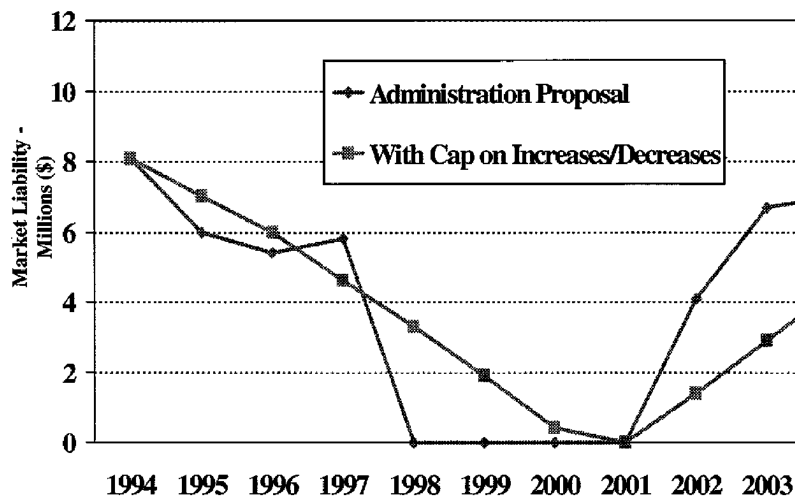
Incentives for Improved Funding: The administration proposal has less incentive for employers to contribute more than the minimum, due to (1) eliminating the credit balance and (2) not allowing employers any economic advantage for super surpluses. In fact, their proposal to eliminate the credit balance has already discouraged some employers from contributing this year, even though they may be cash rich due to a law encouraging repatriation of funds from oversees. We would tighten up the rules for the credit balance, such as growing it at the same rate at which the plan assets grow (as discussed in the Academy's fact sheet on credit balances). With this fix, credit balances could actually increase the funding levels shown in PBGC's white paper on funding. Congress could also restrict the use of the credit balance if funding falls below a specified level, or it could always require that the normal cost be paid. These would improve funding levels beyond those found in the administration proposal.

The administration proposal would allow deductible contributions until plan assets equaled 130 percent of liabilities, which is good, but it only *allows* greater contributions. It won't work unless sponsors can get economic value for plan surpluses, as suggested in our analysis of the administration proposal on pages 5 and 6.

The Academy had concerns about prior proposals to access plan assets in the 1990s, but that is because the threshold, based on a smoothed liability number, was set far too low. In addition, the proposal encouraged companies to take the surplus by eliminating the excise tax for only a short period. There are better ways to make this idea work for both employers and employees, and we would be happy to work with you on this.

Assumption Setting: The administration proposal sets the retirement assumption for at-risk companies, but as discussed earlier, it would produce inaccurate assumptions for companies that are poorly rated, but have a low probability of terminating. History has shown that using the law and regulations to specify actuarial assumptions has not been successful, as evidenced by the delays in setting the discount assumption and the long-running debate on replacing the currently required 1983GAM mortality table. We recommend that the law allow actuaries to set the mortality assumption because mortality experience differs by plan participant populations. Large plans could use actual experience (with an assumption for expected mortality improvement), and smaller plans could use tables with collar adjustments, as suggested in our December 2003 letter to the Internal Revenue Service on this issue. The law and actuarial standards both now require each assumption to be individually reasonable for single employer plans, which is a stronger rule than when Congress first started specifying assumptions. We also suggest the actuary continue to set the retirement assumption. If there are concerns that the individually reasonable rules are not strong enough, then actuaries could be required to justify their assumptions in writing if they seem out of the ordinary.

Yield Curves: The administration's yield curve provision, when compared with an equivalent rate determined from a typical plan, would increase the liability numbers by around 1 percent for unusually mature plans and decrease them by around 1 percent for unusually young plans. A single interest rate could be selected to achieve the same liability amount for a typical plan. Thus, instead of a plan being say 100 percent funded, for example, the unusually old or young plans might be 99 percent funded or 101 percent funded, respectively. If the yield curves are steep, which happens in recessions, then the results would be further apart, but analysis has shown it would be at most 3 percent or 4 percent. Thus, in aggregate, the charts in PBGC's white paper showing total funding in the pension system would be about the same. The charts showing the plans that PBGC takes over (and PBGC's deficit) would be worse, since they are more likely to take over mature plans during recessions, but the difference is so small that the change to their graphs would be subtle.



In summary, you will note from above, that the use of an anti-volatility mechanism and an equivalent rate instead of a yield curve, and the retention of a modified credit balance provision, if done in connection with funding margins, will achieve similar and sometimes better funding levels when compared with the administration proposal, particularly if a shorter amortization period is used. I hope these comments have been helpful in responding to your question. Please let Heather Jerbi or myself know if we can be of further assistance by calling us at 202–223–8196.

Sincerely,

RON GEBHARDTSBAUER, MAAA, EA, FCA, FSA, MSPA,
Senior Pension Fellow,
American Academy of Actuaries.

RESPONSE TO QUESTIONS OF SENATOR KENNEDY BY BRADLEY BELT

Question 1. The President's Proposal would require companies to take future benefits that they have promised workers and in some cases would abruptly cut off workers' future earned pensions. Has the PBGC done any projections of what percentage of plans would be subject to these restrictions and how many workers would see their pension benefits harmed? What are the results of these projections?

Answer 1. The President's proposal would prevent plans from making false promises they can't afford to keep, promises that workers may rely on to their detriment. Requiring that new benefits be either fully funded or delayed until existing benefits are reasonably funded prevents workers, retirees and their families from finding out too late that the benefits they were promised are not there.

Under the President's proposal, the benefit limitations will apply only when a plan's funded status falls below acceptable levels and will depend on the financial health of the plan sponsor. Plans with financially weak sponsors that are funded at a level less than or equal to 80 percent of their target funding liability will be restricted from offering lump sums or increasing benefits. If funding is less than or equal to 60 percent of target liabilities, accruals will also stop. Plans with healthy sponsors will be restricted from increasing benefits if they are funded at a level less than or equal to 80 percent of their funding target and from offering lump sums if they are at a level less than or equal to 60 percent of their funding target.

PBGC used its Pension Insurance Modeling System (PIMS) to model the effects of the proposal on a sample of 369 large pension plans. The 369 plans are loaded into the model with data on assets and current liabilities as of January 1, 2002, the most recent data available. The sample plans are not intended to reflect the entire universe of single-employer defined benefit plans. (Information about the PIMS model may be found at http://www.pbgc.gov/publications/databook/databk98.pdf).

The table below shows the number of plans in the sample of 369 plans that would fall into each of the benefit limitation categories as of January 1, 2002, had the benefit limitation provisions been in effect at that time. The table also shows the limitations that apply in each category.

Distribution of 369 Sample Plans, By Benefit Limitation Category

Target liability funded percentage*	Financially weak sponsor		Healthy sponsor	
	Plans (number and % of sample)	Restriction	Plans (number and % of sample)	Restriction
Over 80%	14 plans(4%)	No restrictions	64 plans (45%)	No restrictions.
Over 60% but less than or equal to 80%.	44 plans (12%)	No benefit increases or lump sums.	119 plans (32%)	No benefit increases.
60% or less	16 plans (4%)	No benefit increases, lump sums or accruals.	12 plans (3%)	No benefit increases or lump sums.

* Market value of assets divided by target liability as of 1-01-02.

Note that the numbers and percentages in the above table will vary significantly over time as discount rates, asset returns, employer contribution rates and other factors vary, and have changed since then.

Also note that employers may "fund up" their plans to avoid benefit restrictions.

Question 2. Many of us are concerned that a number of burdens in the President's plan would drive healthy companies out of our voluntary defined benefit system. Has the agency projected what percentage of employers has the agency projected may leave the defined benefit system as a direct result of the President's plan? If not, why not? If so, will you please share your results with us?

Answer 2. We have heard these assertions before, but we have never seen any evidence that they are valid. We have not seen any qualitative analysis that the administration's proposal will drive healthy companies out of the system. Indeed, under current laws and regulations, thousands of companies are exiting the system. The number of single-employer defined benefit plans insured by PBGC has been declining for many years—from a high of 112,000 in 1985 to 54,000 in 1995, and to 30,000 in 2004.

The administration's proposal would strengthen the system by placing both individual pension plans and the pension insurance program on sounder financial footings. Under the current system, there are significant disincentives for new employers to create defined benefit plans, such as the substancial deficit of the sponsor-financed insurance fund. Prospective defined benefit sponsors are also aware that the current complex system of funding fules allows some sponsors to transfer the risks of their funding and investment decisions to that same insurance system. We believe that these considerations—risk transfers and administrative complexities—also make defined benefit plans unattractive to prospective plan sponsors.

The administration's proposal will correct these flaws. Simplifying the rules, tightening funding requirements, and returning the pension insurance program to financial health will make defined benefit plans more attractive to employers who are now outside the system.

The administration also believes that Congress should act promptly to clarify the legal status of cash balance and other hybrid pension plans. Nearly all the new defined benefit plans created in recent years have been alternative benefit structures, such as arrangements for small businesses (e.g., insurance contracts under

Codesection 412(i)) and cash balance or pension equity plans, which are designed to meet the needs of a younger, more mobile workforce. Unfortunately, as a result of a singel Federal court decision, the legal status of these types of plans is in question.[1]

There are difficulties inherent in modeling future behavior. For example, if employers choose to leave the defined benefit system, they must contribute enough to eliminate the underfunding to do so. If they contribute that much, the plans would no longer be underfunded and would be much less of a financial burden on the employer. Given the amount of underfunding in some plans, sponsors may not have sufficient cash resources available to enable a standard termination. In addition, there are other limits on an employer's ability to leave the pension system, including collective bargaining agreements.

Question 3. By changing the pension funding rules, you will also change the funding percentage of pension plans. For example, a plan that is 100 percent funded today may only be 85 percent funded under the President's new framework, and, if it is a below-investment grade rated company, it may be 80 percent funded or less. Has PBGC modeled how companies' funding percentages will be affected? I ask that you provide us with that information.

Answer 3. One of the problems with current law is that a plan's funding percentage is measured differently for different purposes. A plan may be 100 percent funded under one measure and only 80 percent funded under another. So, the answer to the question "how much will a particular plan's funding percentage change" under the proposal depends on which measure is used as a starting point. For purposes of this question and answer, we will assume the starting point is the current liability funded ratio as that is one of the most common measurements. It is the ratio of assets (which may be determined under a formula that smoothes fluctuations in the market value of assets by averaging the value over a number of years) to current liability (which is the liability measure used in the deficit reduction contribution calculation). Current liability is a "smoothed" liability in that it is based on a 4-year weighted average bond yield. The current liability ratio, however, does not provide a true picture of a plan's funded level, thereby masking the underfunding problem.

The President's proposal uses a "mark to market" approach to replace both the liability and asset measures. Assets will be valued at market value rather than smoothed. Target liabilities will be valued using a corporate bond yield curve and other assumptions appropriate to the financial health of the plan sponsor. In addition, under the proposal, the mandated mortality table underlying the liability calculations will be updated to reflect mortality improvements.

It is difficult to predict exactly how a particular plan will be affected. Furthermore, it is important to note that the impact depends largely on the economic environment at the time of the comparison. For example, when interest rates are rising, using a "mark to market" approach results in lower liabilities. However, in an environment where interest rates are dropping, the liability would be higher under a "mark to market" approach.

Using the same 369 plans and the PIMS model discussed in our response to question (1), we compared the funded ratios based on current liability and smoothed assets with the ratios based on target liability and market value of assets. As of January 1, 2002, using the administration's proposed measures resulted in an average decrease in funded ratios of 25.0 percentage points for plans of financially weak sponsors and 17.2 percentage points for plans of healthy sponsors. Note that the results would be different in other economic environments, and likely have changed since 2002. For example, the smoothed values of assets generally exceeded market values as of January 1, 2002, but that may not be the case at the time of implementation of a change in the law (2006).

Question 4. The administration has proposed eliminating shutdown benefits. These benefits are very prevalent in the steel and rubber industries, which are subject to cyclical downturns. The elimination of these benefits would be devastating for workers and families and even whole towns because in many cases, the plant that is closing may be the only major employer in a community. Has the administration looked at the devastating economic effects this policy will have on communities like this?

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[1] *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).

Answer 4. The administration has not proposed eliminating shutdown benefits. Rather, the administration proposal would prospectively prohibit these benefits from being paid from pension plan assets. These benefits could continue to be provided outside the pension plan.

The reason for this approach is that shutdown benefits are more in the nature of severance benefits rather than retirement benefits and should not be paid by pension plans. Moreover, shutdowns frequently occur in financially-troubled companies with underfunded plans. When shutdown benefits are paid prior to plan termination, they drain the plan of assets that would otherwise go to pay non-guaranteed retirement benefits after plan termination. These benefits generally are not funded until the shutdown occurs, by which time it is often too late. However, despite the lack of funding, shutdown benefits may be guaranteed if the shutdown occurs before the plan termination date, often imposing large losses on the insurance program.

Question 5. I understand that a large part of the agency's projected $23 billion deficit is attributable to predicted airline pension plan terminations. The PBGC should thus be focused on short-term solutions to address this immediate issue, but no such solutions are proposed in the President's plan. What is the current estimate of what portion of this projected deficit is attributable to airline pension plans? What steps has PBGC taken or will it take in the near future to prevent these airline pension plans from terminating and to protect workers from losing their benefits?

Answer 5. In general, PBGC is not able to break down its current deficit by plan or by industry. We do track total claims by industry as plans are trusteed. Of the $20.6 billion of claims for plans that had been trusteed by PBGC through September 30, 2004, $2.9 billion or 14 percent were from the airline industry. Since September 30, 2004, PBGC has taken claims of an additional $9.7 billion for plans that had not been trusteed as of that date, but had already been included in our deficit as part of "probable" claims of $16.9 billion. Of the $9.7 billion, $8.9 billion was for airlines and $0.8 billion was for other plans. We also trusteed "non-probable" plans with claims of $0.4 billion. The combined results are shown in the chart below.

PBGC Claims From Airlines and Other Industries

	All Plans	Plans of Airlines	Other Plans
Claims for Plans Trusteed as of 9/30/04	$20.6 billion	$2.9 billion (14%)	$17.7 billion (86%)
Claims for Probables Trusteed or Announced Since 9/30/04	$9.7 billion	$8.9 billion (92%)	$0.8 billion (8%)
Claims for Other Trusteeships 9/30/04 to 4/30/05	$0.4 billion		$0.4 billion (100%)
Total	$30.7 billion	$11.8 billion (38%)	$18.9 billion (62%)

We understand the financial difficulties the airlines are facing. Congress and the administration have provided assistance to the airlines in the form of grants, loan guarantees, and short-term funding relief when such assistance was determined to be appropriate.

The administration's pension reform proposal would strengthen the funding rules to improve the health of the entire defined benefit pension system. This is particularly important for those underfunded plans that pose the greatest risk of terminating. Neither the defined benefit system nor the pension insurance system is designed to provide targeted relief to specific industries. It is designed to insure benefits for participants in plans that fail.

Weak funding rules have been the cause of current difficulties, and we believe that further weakening funding requirements will only exacerbate the problem. It is not in the best interests of participants, other premium payers, or the taxpayer to allow companies to effectively borrow from their employees and the insurance fund to meet their financial obligations.

I would also emphasize that the majority of losses incurred by the PBGC to date have been in industries other than airlines and that the majority of the insurance fund exposure to "reasonably possible" claims is in other industry sectors. The financial pressures on the pension insurance program are not unique to the airline industry.

Current law allows plan sponsors to obtain funding waivers if they are experiencing temporary substantial business hardship. The IRS can, in consultation with the

PBGC, impose conditions on obtaining a waiver that will protect the interests of participants and the pension insurance program. As the airline situation is not temporary, relief is not permitted under current law. Providing this relief would not solve, and might worsen, the problem for workers, retirees, and the pension insurance program.

PBGC will use the tools at its disposal to ensure that companies, including airlines, comply with applicable laws and regulations before they are able to shed their pension obligations onto the insurance program. Ultimately, however, current law allows companies to shift those costs if they are able to demonstrate to a bankruptcy judge that they would not be able to emerge from bankruptcy with their pension plans intact. The court makes that determination, not PBGC.

RESPONSE TO QUESTIONS OF SENATOR MIKULSKI BY BRADLEY BELT

PBGC took over the pension plan of Bethlehem Steel in December of 2002. PBGC now pays the pensions of Bethlehem Steel retirees and will pay the benefits of workers who have not yet retired. After the takeover, Beth Steel retirees continued to collect their normal pension benefits. Nearly 1 year later, PBGC told thousands of the retirees their monthly benefit check was more than it should have been—something PBGC calls "benefit overpayments." These retirees were also told they had to repay the "overpayment." A reduction in benefits for someone on a fixed income is hard enough—but to repay the PBGC is truly a hardship.

These overpayments affected about 3,000 Maryland retirees and about 11,000 Bethlehem Steel retirees. Some of them were expected to repay as much as $15,000!

After this happened, I wrote to PBGC to ask forgiveness of these overpayments. There are other Federal agencies that forgive overpayments and I asked if the same could be done for these workers. I was told by Steven Kandarian (former Executive Director) that the PBGC is required by law to recoup any overpayments.

I understand that calculating pension benefits can be complicated, but we all know that most elderly Americans do not have extra money to be paying government agencies for administrative glitches. Though you many not see it as the fault of the PBGC, it certainly is not the fault of the individual steel worker.

There must be a better way!

Question 1. How do we make sure something like this doesn't happen in the future?

Answer 1. We agree that we must find a better way, but in doing so we should understand what caused the problem in the first place. By way of brief background, Bethlehem Steel chose to operate a chronically underfunded pension plan for many years. Bethlehem Steel did this by taking full advantage of very weak minimum funding rules that are statutorily established under ERISA and the Internal Revenue Code. As a result, by October 2001, when Bethlehem Steel filed for bankruptcy, its pension plan was only 45 percent funded, with over $4 billion of unfunded pension promises.

Unfortunately, under current law there is no way to prevent this from happening again. As long as the law allows companies to significantly underfund their plans, as Bethlehem did and hundreds of other companies are still doing today, then retirees are at risk of losing the benefits they earned through a lifetime of hard work.

When these companies go bankrupt and their plans are terminated, retirees continue to receive benefits at the plan level, rather than at the lower limits provided under Title IV of ERISA, until the plans are trusteed by PBGC. This process often takes many months because of delays in signing trusteeship agreements, the tremendous complexity of the company/union negotiated plan provisions, and the complexity inherent in the statutory guarantee limits and asset allocation rules under Title IV of ERISA. As a consequence, overpayments can continue for some time. By law, the PBGC is required to seek repayment of those overpayments.

The best way to protect retirees in future terminations from difficulties like those faced by retirees in the Bethlehem plan is for Congress to promptly pass the administration's pension reform package. Companies should be required to fully fund their own pension promises; to be open about the financial condition of their pension plans; and to stop making new, empty promises when they have failed to fund their past pension commitments. Until Congress acts to prevent these abuses, retirees will continue to suffer.

Question 2. What would you suggest we do to prevent this hardship on retirees?

Answer 2. The PBGC already makes every effort to mitigate the impact of recoupment on retirees. We inform them about the benefit limitations of ERISA that apply to terminated plans so that they are aware of the potential overpayments in the benefits they are receiving after the plans terminate. We apply the statutory

benefit limitations of ERISA as quickly as we can. And we seek repayment in a way that mitigates hardship.

We mitigate recoupment hardship in several ways. Under the regulation that implements the statutory recoupment requirement, a participant's (and any survivor's) monthly benefit payable by the PBGC under Title IV of ERISA is reduced by an amount that would result in the overpayment being repaid over the participant's expected remaining lifetime, based on the participant's age, without interest. Regulations provide that the recoupment amount is limited to 10 percent of the monthly benefit payable by the PBGC. (The vast majority of recoupment amounts are much less than 10 percent.) When the overpayment amount has been fully repaid, without interest, the PBGC stops recoupment and restores the full benefit payable under Title IV of ERISA.

Question 3. Given computing power now available, why is there such a delay in the overpayments?

Answer 3. The PBGC must have access to plan and participant records before we can even start the process of determining benefits payable by the PBGC. In some plans, access is difficult or delayed because terminating a pension plan may be contentious or simply of secondary importance to the employer. In other situations, plan and participant records are in disarray or missing.

The PBGC worked with Bethlehem Steel, other creditors, and the unions, to see if the pension plan could continue; but by December 2002 it became clear that the plan's termination was inevitable. Unfortunately, even though Bethlehem's CEO had said publicly for many months that plan termination was unavoidable, the company refused to sign the trusteeship documents until April 30, 2003. During this 5-month period, Bethlehem continued paying retirees their full plan benefits knowing that thousands of the payments they were making each month were in excess of the limits set by law and would ultimately have to be repaid.

Upon becoming trustee on April 30, 2003, and finally gaining access to the company's pension records, the PBGC began reviewing benefits being paid to Bethlehem's 70,000 retirees. During this initial review process we must analyze each participant's benefit in light of the very complex set of guarantee limits and asset allocation rules required by Title IV of ERISA. This process took 6 months and resulted in PBGC's identifying 11,000 retirees whose benefit payments were in excess of the statutory guarantee limits. PBGC notified participants and reduced benefits of those being overpaid. Unfortunately, these participants had been receiving their full plan benefits for 11 months after the date the plan ended.

The PBGC is acutely aware of the need to calculate participants' guaranteed benefits as early as possible. We are constantly striving to find methods to enable us to calculate benefits earlier. As we did in Bethlehem Steel, the PBGC now starts the analysis of pension plan provisions and policy issues (where applicable) as soon as we become aware of an impending termination.

Prepared Statement of the National Rural Electric Cooperative Association

Mr. Chairman, and members of the committee, the National Rural Electric Cooperative Association (NRECA) is a not-for-profit national service organization representing approximately 930 not-for-profit, consumer-owned rural electric cooperatives that serve over 37 million Americans in 47 States. Our members are generally small businesses (as few as four employees), with a median of 43 employees across the country. With over 58,000 total employees and retirees of NRECA's members enrolled in NRECA-sponsored defined benefit (DB) pension plans throughout the United States, I thank Chairman DeWine and Ranking Member Mikulski for convening this hearing on the critical issue of preserving private-sector retirement savings plans, and the PBGC, in the future.

We remain committed to the consumers we serve as well as to the cooperative employees who ensure the consistent delivery of safe and affordable energy throughout rural America. In pursuit of this goal, the vast majority of our members provide their employees with the NRECA-sponsored and administered "multiple-employer" DB pension plan under § 413(c) of the Code. Approximately 900 individual rural electric cooperatives participate in NRECA's DB Plan covering over 58,000 total employees and retirees throughout the United States. The principle of **Cooperation Among Cooperatives** calls on cooperatives to "serve their members most effectively and strengthen the cooperative movement by working together . . . ." NRECA's "multiple-employer" DB pension plan is a shining example of this principle, as it provides cooperatives with a convenient and affordable mechanism to pool resources, maximize group purchasing power and leverage economies of scale

that would otherwise be unavailable to small businesses like cooperatives. Our DB plan is one of our most popular member benefits.

Concerns with the administration's Proposal on Defined-Benefit Plans— NRECA believes that the administration has raised very important issues that need to be addressed in order to strengthen the private retirement plan system. We support certain principles underlying the administration's proposal, including the need to strengthen funding requirements and improve disclosure. However, we have several concerns with respect to the proposal that we believe need to be addressed to avoid causing harm to the system—particularly in the areas pertaining to predictability, how the PBGC values plan assets and liabilities, and how these PBGC calculations could force rural electric cooperatives from the voluntary defined-benefit plan system. As this hearing is focused on the PBGC, I will address those specific issues first.

PBGC Premiums. First, we have serious questions about the size of PBGC's deficit, especially since the deficit number that PBGC has announced was determined based on a below-market and inappropriate interest rate. We also have questions about the extent to which small increases in interest rates and the equity markets would reduce the PBGC deficit. We strongly urge that no legislative action be taken on premiums until those fundamental issues are resolved.

To address this "deficit," the administration has proposed more than a 50 percent increase in the flat-rate premium (from $19 per participant to $30), and has proposed indexing the premium prospectively. This proposal alone would raise $2 billion over 5 years. In addition, the administration proposes raising an additional $13.5 billion (for a total of $15.5 billion over 5 years) in its fiscal year 2006 Budget.

The proposed increase in the flat-rate premium and additional premium increases in the fiscal year 2006 Budget would be a direct "tax hike" on our consumer-owners. How so?

It is important to remember that electric cooperatives operate "at cost," meaning that any increases in operational costs or government fees have to be passed on directly to our consumer-owners. For example, if the administration's proposal to raise this $15.5 billion comes from flat-rate premiums alone, the current $19 per participant figure would have to be raised to approximately $104.

This would result in a stunning "tax hike" of just under $5 million that would have to be borne by our consumer-owners in 2006 alone. This would also unfairly burden all other employers that have stayed in the defined benefit plan system through the perfect storm of low interest rates and low equity values.

In your State of Ohio alone, Mr. Chairman, this would mean that the 25 co-ops that participate in NRECA's defined-benefit plan would have to pass on nearly $100,000 in electricity rate increases to their consumer-owners with no additional benefits whatsoever. Here is how the proposal would affect all members of the subcommittee:

Senator	State	Co-ops	Employee participants		Increased electricity cost to consumer-owners
Isakson	Georgia	46	3988		$338,980
Sessions	Alabama	21	1934		$164,390
Roberts	Kansas	30	1265		$107,525
DeWine	Ohio	25	1172	x $85	$99,620
Hatch	Utah	7	481	PBGC	$40,885
Bingaman	New Mexico	11	415	Premium	$35,275
Mikulski	Maryland	2	158	Increase	$13,430
Jeffords	Vermont	2	98		$8,330
Clinton	New York	8	153		$13,005
Total Electricity Rate Increase For Subcommittee Member States					$821,440

For Chairman Enzi's constituents, Wyoming's 13 co-ops that participate in NRECA's defined-benefit plan would have to pass on nearly $34,000 in electricity rate increases to their consumers with no additional benefits whatsoever. A complete state-by-state and co-op by co-op breakdown of the administration proposed 547 percent increase in PBGC flat-rate premiums and its affect on rural electric cooperative consumer-owners is available.

More globally, NRECA strongly believes that these massive increases in premiums would have extremely adverse effects on the defined benefit plan system, leading to many fewer plans and lower benefits.

The administration has also proposed that the PBGC's Board control the level of the variable rate premium (which is renamed the risk-based premium) to cover PBGC's expected losses and improve its financial condition. We have grave concerns about the PBGC setting its own premiums. That is a Congressional function and should remain so.

Further, any dramatic increase in the variable rate premium would inappropriately burden those plans experiencing a downturn in its sponsor's business cycle, harming the Plan's ability to recover. This is contrary to the interests of the participants, the Plan sponsors, and the PBGC.

Finally, we believe that any proposed increases in PBGC premiums should not be considered as part of the fiscal year 2006 budget resolution. As pension funding and PBGC premiums are inextricably intertwined, we firmly believe that setting premium increase targets in the fiscal year 2006 budget resolution will make a full discussion of pension funding reform virtually impossible.

These concerns with specific PBGC issues, however, cannot be viewed in a vacuum. All other aspects of the administration's DB pension proposal will have a direct impact on the function, utility, and obligations of the PBGC in the future.

Predictability. The administration has proposed that a plan's funding and premium obligations be based on a spot valuation of assets and a near-spot valuation of interest rates. It can be shown based on historical data that such snapshot valuations are not accurate measures of a plan's funded status for the following year. Moreover, such snapshot valuations cause severe planning problems, as discussed below.

A critical issue for Cooperatives and all employers that sponsor defined benefit plans is predictability. This is especially true in the utility area, where Cooperatives need to be able to make cash flow and capital investment projections that are taken into account for purposes of setting rates. Under the administration's spot valuation proposal, a plan's funded status could easily vary by over 10 percent during the last 3 months of a year, thereby dramatically altering the following year's funding and variable rate premium requirements. This is an unworkable situation for Cooperatives and will clearly hurt planning and growth, as well as cause many Cooperatives and other companies to leave the defined benefit plan system.

There are two ways to address the predictability concern. The first, which NRECA supports, is to retain the current-law rules that permit changes in asset values and interest rates to be recognized over time to mitigate short-run changes in liabilities (by reason of interest rate fluctuations) and in the fair market value of plan assets ("front-end smoothing"). The second, which NRECA opposes, is to use spot valuations to measure assets and liabilities, but "smooth" on the "back-end" by smoothing both contribution obligations and the application of the numerous other rules that are based on a plan's funded status. We strongly believe that the latter approach would be quite complex and, in the end, unworkable.

Liability Measurement. The administration has proposed using a near-spot yield curve to measure liabilities. NRECA has two major concerns with respect to this aspect of the proposal. First, as discussed above, preserving the current-law interest rate averaging rules is critical.

Second, use of a yield curve should not have the effect of lowering the effective interest rate for the average plan.

We do not favor the yield curve, but if a yield curve is used, it needs to be based on a 4-year weighted average of yield curve interest rates. The yield curve would also need to be based on rates both above and below the long-term corporate bond rate so that the effective rate for the average plan is the long-term corporate bond rate.

Lump Sum Distributions. NRECA's DB Plan offers lump sums and approximately 92 percent of our participants elect a lump sum distribution. A very large number of those participants—particularly the older participants—roll over their lump sum distribution to an IRA and prudently manage their IRA savings during retirement. This lump sum option is a highly valued feature of our plan.

The administration has proposed applying a yield curve to determine the amount of a lump sum distribution. We believe that this would result in artificially large lump sums that could threaten the ongoing viability of our Plan. Moreover, this proposal makes very little sense. Since retirees with longer life expectancies are increasingly (and prudently) investing in equities, determining their lump sum benefits based on hypothetical bonds that they are not investing in is inappropriate. And it will be impossible to explain to employees working side by side that their lump sum benefits are calculated using different interest rates based on their age. In ad-

dition, contrary to sound public policy, artificially large lump sums make annuities look unattractive, increasing the risk that employees will outlive their assets.

We strongly believe that after a significant transition period (i.e., 5 to 7 years), lump sum distributions should be determined based on the long-term corporate bond rate.

Credit Rating. Under the administration's proposal, a plan's funding target or liability would be increased based on a company's credit rating, resulting in potentially dramatic increases in funding and premiums for companies in junk bond status.

As applied specifically to NRECA's DB plan, the administration's credit rating proposal is simply unworkable. Our plan is a multiple employer plan (not a multiemployer plan) in which nearly 900 different cooperatives participate. Depending on how one interprets this unclear part of the administration's proposal, either all 900 cooperatives would be rated by the Federal Government or approximately 20 of the bigger ones would be rated. We strongly object to the Federal Government getting into the business of evaluating the viability of our Cooperatives. And if some cooperatives are rated as in junk bond status, and others are not, it begs the question—why should that affect our Plan in any way since our Plan is a single plan that does not terminate if a Cooperative goes out of business or otherwise leaves the Plan?

Administration officials have publicly admitted that they never considered multiple employer plans in developing their proposal, which simply does not work in that context.

Credit Balances. Current law is carefully structured to be neutral with respect to advance funding. If a company pre-pays future funding obligations, the plan has a "credit balance" that can be used to offset future funding obligations.

The administration has proposed eliminating credit balances. We see this as both unfair (with respect to existing credit balances) and ill-advised. It is ill-advised because it can be shown mathematically that the administration's proposal will systematically discourage companies from contributing above the minimum amount required.

Summary. Cooperative businesses are special because they are owned by the consumers they serve and because they are guided by principles that reflect the best interests of those consumers. One of these principles is Concern for Community, which calls on all Cooperatives to work for the sustainable development of their communities through policies accepted by their members. Being able to work with our members and their employees to provide a safe and secure retirement to their workers is part of our Concern for Community.

NRECA strongly believes that any reforms to the DB retirement savings system should continue to encourage workers to provide for their own economic security, while at the same time encourage employers to continue to sponsor benefit plans. We hope to continue our work with the subcommittee to address the challenges of administering and participating in a DB pension plan, particularly "multiple-employer" plans like NRECA, so they remain a viable vehicle in the future for companies trying to do the right thing—providing meaningful retirement benefits to their employees.

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[Whereupon, at 11:30 a.m., the subcommittee was adjourned.]

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