EXAMINING PENSION SECURITY AND DEFINED BENEFIT PLANS: THE BUSH ADMINISTRATION'S PROPOSAL TO REPLACE THE 30-YEAR TREASURY RATE

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

OF THE

COMMITTEE ON EDUCATION AND THE WORKFORCE

AND THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

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EXAMINING PENSION SECURITY AND DEFINED BENEFIT PLANS: THE BUSH ADMINISTRATION'S PROPOSAL TO REPLACE THE 30-YEAR TREASURY RATE

Tuesday, July 15, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON EDUCATION AND THE WORKFORCE
SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

and

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittees met, pursuant to notice, at 2:00 p.m., in room 2175, Rayburn House Office Building, Hon. Sam Johnson and Hon. Jim McCrery (Chairmen of the Subcommittees) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE | CONTACT: (202) 226–5911
July 08, 2003
SRM–3

McCrery Announces Joint Hearing on Examining Pension Security and Defined Benefit Plans: The Bush Administration's Proposal to Replace the 30-Year Treasury Rate

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a joint hearing with the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce on the Administration's proposal to replace the 30-year Treasury rate. **The hearing will take place on Tuesday, July 15, 2003, in 2175 Rayburn House Office Building, beginning at 2:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Under present law, pension plans are required to use the 30-year Treasury bond rate for a variety of defined benefit pension calculations. For example, the 30-year Treasury rate is used to calculate funding requirements, certain premium payments to the Pension Benefit Guaranty Corporation (PBGC), and lump sum distributions.

As a result of the U.S. Department of the Treasury's debt buyback program and the subsequent discontinuation of the 30-year Treasury bond, the interest rate on outstanding 30-year bonds has fallen significantly. Businesses have expressed concerns that this very low rate results in an overstatement of their actual liabilities, thus forcing them to make artificially inflated payments to their pension plans and to the PBGC.

In 2002, the Congress enacted temporary relief in the *Job Creation and Worker Assistance Act* (P.L. 107–147). The new law temporarily raises the permissible interest rate which may be used to calculate a plan's current liability and variable rate PBGC premiums. The provision applies to plan years 2002 and 2003.

On April 30, the Subcommittee held a hearing to explore options for a permanent and comprehensive replacement. At the hearing, the U.S. Department of the Treasury recommended extending the temporary relief provided under P.L. 107–147 by an additional two years to give the Administration additional time to formulate a permanent and comprehensive solution.

On July 7, the Administration formally announced a permanent solution. The solution would replace the 30-year Treasury rate used for pension calculations and would implement other funding reforms.

In announcing the hearing, Chairman McCrery stated, "At the April hearing before the Subcommittee on Select Revenue Measures, there was bi-partisan agreement that the current method of calculating future pension plan liabilities is unsustainable. At the time, both Members of Congress and witnesses expressed frustration that the Treasury Department was proposing only a temporary extension of the existing formula. I am pleased they have joined us in recognizing this problem requires a permanent, comprehensive solution. This hearing will provide the Congress with an opportunity to analyze the Administration's recently unveiled plan. Given the exigencies of this issue, I am hopeful the hearing will pave the way for swift legislative action."

FOCUS OF THE HEARING:

The focus of the hearing is to examine the Administration's proposal to replace the 30-year Treasury rate with a yield curve discount rate and to implement other pension funding reforms.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Tuesday, July 29, 2003. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, in WordPerfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman JOHNSON. Good afternoon. A quorum being present, a joint hearing, and I emphasize joint, of the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce, and the Subcommittee on Select Revenue Measures of the Committee on Ways and Means will come to order. I would like to thank my colleague from Louisiana, the Chairman of the Subcommittee on Select Revenue Measures, Chairman McCrery, agreeing to hold this joint hearing on examining pension security and defined benefit plans. That is also the Bush plan to replace the 30-year Treasury rate.

So we can get to our witnesses, we have agreed to limit opening statements to the Chairmen and Ranking Members of each Subcommittee. With that, I ask unanimous consent that the record remain open for 14 days to allow Members to insert extraneous material into the official hearing record. Without objection, so ordered. We are going to continue here without Mr. McNulty, who is on his way and will arrive shortly. I wish you a good afternoon, and welcome to a historic hearing on a very important issue before these two Subcommittees, the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce and the Subcommittee on Select Revenue Measures of the Committee on Ways and Means.

I would like to, at this point, welcome my Co-Chairman, Jim McCrery, who is sitting to my left, and our Ranking Member, Rob Andrews. Later hopefully, Mike McNulty. As a Member of both full Committees, I particularly appreciate the efforts of Chairman Boehner and Chairman Thomas to work together on issues of joint jurisdiction, and especially on this critical issue of pension security for American workers. Today, we are eager to hear the Members of the administration explain their recent proposal regarding defined benefit pension rules, and this hearing is the second in a series of hearings that this Subcommittee has held on the issue of defined benefit plans.

As we learned in our previous hearing, the number of defined benefit plans has been declining for years, in part, due to overregulation, and we are currently at the center of a perfect storm, if you will, with plans struggling under down market, low interest rates and an aging workforce. The Employee Retirement Income Security Act (ERISA) (P.L. 93–406) and the Internal Revenue Code required companies to evaluate the costs of projected benefit payments and then set aside cash to fund those payments. The interest rate used to determine how much interest their cash might earn is the subject of this hearing because that rate was the 30-year Treasury bond. Almost 2 years ago, the U.S. Department of the Treasury stopped issuing the 30-year Treasury bond, and the temporary fix we legislated will expire in less than 6 months.

I believe everyone on the dais today understands the urgency for workers, companies, and taxpayers of finding a suitable long-term replacement for the 30-year Treasury bill rate for pension funding purposes. It is in everyone's best interest if pension promises are funded at accurate levels. Overfunded plans leave companies making unnecessary contributions that take away funds from capital improvements or hiring new employees. Underfunded plans leave workers and retirees at the risk of losing benefits that could leave taxpayers at risk through the Pension Benefit Guaranty Corp. (PBGC). Last week, the Administration proposed changes that would move the measurement of liabilities away from the 30-year Treasury bill to a corporate bond blend rate.

The proposal also increases pension funding disclosures to employees and limits the ability of financially troubled companies to increase benefits. In our first panel, we will hear the Administration's efforts to bring a proposal to the table and look forward to hearing definitive details of the proposal. We want to work toward a permanent solution.

Our second panel today will consist of witnesses with expertise in the pension industry who will give us their responses to the Administration's proposal and their perspective on the health of defined benefit plans. The panel consists of representatives of the business community, actuaries, and academics. I am hopeful that all witnesses today will be able to enlighten both Subcommittees on the important task of preserving our defined benefit system and continuing to encourage employers to provide retirement security for American workers.

I think that at this point, I would like to recognize my Co-Chairman of this hearing, and the Chairman of the Subcommittee on Select Revenue Measures, Chairman McCrery, for purposes of making an opening statement. Chairman McCrery, you are recognized.

[The opening statement of Chairman Johnson follows:]

Opening Statement of The Honorable Sam Johnson, Chairman, Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce, and a Representative in Congress from the State of Texas

Good afternoon and welcome to an historic hearing on a very important issue before these two Subcommittees—the Employer-Employee Relations Subcommittee of Education and the Workforce and the Select Revenues Subcommittee of Ways and Means.

I also want to welcome my Co-Chairman Jim McCrery and our ranking members Rob Andrews and Mike McNulty.

As a member of both full Committees, I particularly appreciate the efforts of Chairman Boehner and Chairman Thomas to work together on issues of joint jurisdiction and especially on the critical issue of pension security for American workers.

Today we are eager to hear members of the Administration explain their recent proposal regarding defined benefit pension funding rules.

This hearing is the second in a series of hearings that my Subcommittee has held on the issue of defined benefit plans.

As we learned in our previous hearing, the number of defined benefit plans has been declining for years, in part due to over-regulation.

We are currently at the center of a "Perfect Storm," with plans struggling under a down market, low interest rates, and an aging workforce.

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We appreciate the Administration's efforts to bring a proposal to the table and look forward to hearing definitive details of the proposal.

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The panel consists of representatives of the business community, actuaries, and academics.

I am hopeful that all the witnesses today will be able to enlighten both subcommittees on the important task of preserving our defined benefit system and continuing to encourage employers to provide retirement security to American workers.

Chairman MCCRERY. Thank you, Mr. Chairman. I appreciate the opportunity to join with your Subcommittee on Employer-Employee Relations to explore this very important subject. In the interest of time, I would ask unanimous consent that my opening statement be included in the record of the hearing. It has been submitted to the Subcommittee.

I would like to yield 1 minute of my time for opening statements to Mr. Portman, a Member of the Committee on Ways and Means who has introduced bipartisan legislation covering more than the subject of today's hearing, but it includes that and other issues pertaining to pensions. So, I yield to Mr. Portman.

[The opening statement of Chairman McCrery follows:]

Opening Statement of The Honorable Jim McCrery, Chairman, Subcommittee on Select Revenue Measures, and a Representative in Congress from the State of Louisiana

Thank you, Mr. Chairman. It is a pleasure to join you in co-chairing this joint hearing of our two Subcommittees.

Mr. Chairman, it is well-known that within the Committee on Ways and Means, you bring to the table perspectives shaped by your participation and leadership on the Education and the Workforce Committee. It is an honor to be able to develop some of that perspective first-hand.

This hearing is the Subcommittee on Select Revenue Measures' second foray into the difficult subject of finding a suitable replacement for the now-defunct rate used to calculate the future liabilities of defined benefit plans.

Every witness at our first hearing agreed that the current mechanism, based on a multiple of the four-year weighted average of the rate on 30-year Treasury bonds, is inaccurate, understating the expected growth of plan assets.

That hearing revealed the unanimity of opinion, both on the Subcommittee and among the witnesses, on the need for a permanent replacement for the 30-year rate. I applaud the Treasury Department for heeding that call and coming forward with a proposal.

This hearing will give us a better understanding of the theory behind and the operation of the Administration's yield-curve proposal, which takes into account the term structure of a pension plan's liabilities.

Based upon my review, I believe a yield curve would be a more accurate method of calculating these liabilities than the current system, which applies the same interest rate, regardless of when the plan anticipates paying benefits. I look forward to hearing more about this from Secretary Fisher.

At the same time, the Administration's proposal recognizes that fixing the 30-year rate is but one part of the equation. Our goal can't just be to fix that problem and move on. It must be to strike a balance which ensures funding is adequate to protect the fisc but does not result in funding requirements which unnecessarily burden the defined benefit system.

Accordingly, a comprehensive review of the defined benefit system will also require us to review:

** Mortality tables;
** Expected retirement ages;
** The extent to which companies should be able to increase contributions in good years;
** The effect on plan funding of applying different discount rates to lump sums versus lifetime pay-outs;
** Whether there should be limitations on new benefits or benefit accruals when plans are severely underfunded;
** The benefits and risks of increased transparency, such as the extent to which there should be public disclosure of severely under-funded plans;
** The extent to which discount rates should be "smoothed" and how to balance the certainty and reduced volatility smoothing provides with the effect it has on reducing the accuracy of those rates.
** The length and type of transition which may be necessary to move from current rules to new ones.

While it would be my hope that we enact as soon as possible a permanent replacement for the 30-year rate, any solution which does not address these issues may be premature. I look forward to examining with the witnesses the tension between these competing demands.

Should we find it impossible to develop a comprehensive solution to these multifaceted issues facing defined benefit plan sponsors, beneficiaries, and the public, the problems inherent in the current formula are sufficiently serious to merit an immediate, albeit short-term solution.

I would also like to briefly address the growing interest in carve-outs which would provide special treatment to one industry or another. These proposals are coming from sympathetic industries, in some cases businesses still reeling from the effects of September 11 and the continuing sluggishness of our economy.

When reviewing these proposals, we should carefully consider both the industries' present need for relief as well as the possible long-term implications of such carveouts. Although we will not hear such testimony today, it is clearly a matter of substantial importance.

The defined benefit system has been, and will hopefully continue to be, an integral part of retirement security for millions of Americans. To do so, however, it must be properly funded to ensure that plans have the resources tomorrow to pay for promises made today.

Congress must not create incentives which unintentionally discourage companies and unions from investing plan assets prudently or which allow them to make overly generous promises about future benefits which cannot realistically be met. Rules which facilitate such plan design flaws exacerbate the moral hazard present when a taxpayer-financed backstop exists for terminated plans.

Let me be clear. I support a vibrant defined benefit system, one which is responsibly financed. As we proceed with this hearing and with future legislation, I hope we will keep in mind the importance of providing rules for these plans which take into account the interests of not only employers and employees but also the future taxpayers who will be asked to shoulder the consequences of funding shortfalls.

Thank you, and I yield back the balance of my time.

Mr. PORTMAN. I thank Chairman McCrery, and I want to commend both of you, Chairman McCrery and Chairman Johnson, for holding this hearing, the second one we have had on this topic with the joint Subcommittees. Clearly a permanent solution to the discount rate is needed. It is needed urgently. The 30-year Treasury rate is now obsolete and our temporary fix we put in place 2 years ago expires, as Chairman Johnson has said, very well.

As you know, the Committee on Ways and Means is working with this Committee has put together more comprehensive legislation, the Portman-Cardin legislation, which we had planned to mark up earlier this year. Frankly we had been waiting anticipating a proposal from the Administration. I certainly look forward to discussing the details of the Administration's plan here today so we can move forward with this more comprehensive needed legislation.

At the last joint Subcommittee hearing, I joined others in the panel, including both Chairs, including in urging the Administration to give us a specific proposal as an alternative to the 30-year Treasury rate. Again, we look forward to hearing more about that today. I think this is a very important issue for our economy right now. I think it is one of the factors contributing to a weakened economy. By having this artificial, low 30-year Treasury rate, many companies are contributing more to their pension plans that is needed to fund benefits, which does divert precious resources from investments designed to grow payrolls and jobs and businesses and contribute to an overall economic growth. This is very important. Another reason I think it is important is that day by day, we are seeing companies freezing their pension plans and workers losing their benefits. With that said, Mr. Chairman, I want to thank you both for holding this hearing, and I look forward to the testimony.

Chairman MCCRERY. Thank you Mr. Portman. One of our colleagues on the Committee on Ways and Means who has introduced bipartisan legislation on one facet of this problem, Dave Camp from Michigan. I would like to recognize Mr. Camp for a brief statement.

Mr. CAMP. Thank you, Mr. Chairman. Again, I also want to thank Chairman Johnson and Chairman McCrery for the opportunity to express support for their efforts to update the 30-year Treasury bond, but I would like to bring attention to a year bill I recently introduced, H.R. 2719, which would provide temporary relief for certain defined benefit plans that have been maintained by commercial airlines without any cost to taxpayers, and all of this while maintaining their normal pension payments.

The Treasury Department proposal that is being examined today does not provide airlines with needed relief, and I know there are a number of pilots who made an effort to be at this hearing today, and I thank them for that. The enormous deficit reduction contributions (DRCs) that the airlines are facing is an immediate crisis for the airline industry. Replacing the 30-year Treasury bond would be one step in addressing this crisis, but we need to do more. This legislation would provide relief without making taxpayers pay the bill. Our plan would make airlines continue their normal pension payments and would only allow for the deferral of their surcharge contribution payments temporarily. These payments are government mandated surcharge that was put on during the Clinton Administration on the airlines requiring the airlines to make enormous payments in an unreasonable time period.

The legislation introduced by myself and Mr. Pomeroy would temporarily defer the additional funding contributions required by the DRC for a 5-year period. Airline plans would then pay interest on the unfunded liability for 5 years and amortize the unfunded liability over the next 15 years. The bill protects the PBGC from additional liability in the event an airline's pension's plan is terminated during the 10-year deferral period. In no way would this relieve the airlines from any of their pension liabilities. They will continue to make their normal contributions. I thank the Chairman for giving me an opportunity to discuss this legislation. I realize it is not directly on point with the hearing that you are having today, but it is a part of trying to make sure that our defined benefit plans are not only strong today, but in the future as well. Thank you very much.

[The joint opening statement of Mr. Camp and Mr. Pomeroy follows:]

Chairman MCCRERY. I thank the gentleman for highlighting this issue this Subcommittee will certainly have to consider as we move forward on this issue. With that, Mr. Chairman, I yield back.

Chairman JOHNSON. Thank you and your statement will be entered in the record. Chairman McCrery, I thank you again, and I recognize Ranking Member of the Subcommittee on Employer-Employee Relations, Mr. Rob Andrews, for his opening statement.

Mr. ANDREWS. Thank you, Mr. Chairman, and I would like to thank you and your Co-Chairman for sponsoring this hearing. There are many issues in the pension area where there are significant disagreements. There are 69 million Americans working today with no pension. There have been some serious abuses under the defined contribution system that have been brought to light in recent years, and there will be some significant disagreement. I think this is one area though where there is significant agreement, and we need to move quickly to enact some important legislation. There are employers all over our country who are not investing in new plant, not investing in new equipment, not hiring new workers, perhaps even letting go of workers because of enormous contributions they have to make to pension plans.

Now if the purpose of those contributions is to secure the stability of those plans, then that is what we want to see. If those enormous contributions are triggered by a set of anomalous economic circumstances and, by the need to comply with an outdated and obsolete financial standard, that is not what we want to see. It is important that we solve the problem. The solution that we are looking for—and I would emphasize what Mr. Portman and Chairman Johnson said, it needs urgency of the Congress—is one that combines a couple of elements that we will be looking for both in the Administration proposal and I think we have already seen in Mr. Portman and Mr. Cardin's proposal, which I would embrace.

The first standard is that the new rule promote the stability of pension funds over the long-term. We should enact nothing that in any way erodes, or takes away from the strength of pensions. I think the legislation introduced by Mr. Portman and Mr. Cardin meets that standard. Second, any standard must be fair to individuals. The effect on lump sum distributions must be such that there is no punitive or unfair impact upon individuals receiving a lump sum distribution. Third, the plan must provide for significant and immediate relief for employers. Must be something where employers immediately realize the benefit of restructured pension contributions. We spent a lot of time this year talking about economic stimulus. It is ironic at the same time the Congress is debating economic stimulus, an economic depressant has been rippling through the economy in the form of these enormous pension contributions.

We need to reverse that depressant and complement the stimulus that has already been enacted so our economy can grow.

Finally, it is important that the solution for this problem reflect long-term stability in the law. One of the concerns that I will tell the Administration I have right at the outset is the possibility of an erratic future in this area. I think it is very, very important that people who maintain defined benefit plans, we would like to see a lot more of them. Know with certainty the financial environment in which they are going to be operating and we can quarrel about the technical assets and liabilities of the yield curve approach, but there is one concern that for me is a threshold concern, and that is whether the instability that is built into that approach disqualifies this as a solution.

So, I thank our colleagues for having this hearing. I would urge two things. One is that we stick to the narrow issue before us, which is technical correction of this interest rate discounting problem and not wander off into other more controversial areas, number one; and number two, that we act expeditiously so that companies throughout our country can benefit from this and therefore workers can benefit from it as well. I thank the Chairman for the time.

Chairman JOHNSON. Thank you Mr. Andrews. I now would recognize Ms. Stephanie Tubbs Jones for whatever opening statement you wish to make.

Ms. TUBBS JONES. Thank you Mr. Chairman. I am glad to have the opportunity to participate in this joint Subcommittee hearing, and I will share my time with my colleague over here who has been very active in the area. We are all in agreement on the focus of this hearing. The Administration's proposal for a permanent replacement of the 30-year Treasury rate is a very important issue for every Member of Congress and millions of American workers. Ultimate resolution of this issue will have a major effect on millions of American workers not just for a day or week, but for the duration of their retirement years.

Defined benefit plans, the intended target of this proposal, play a very important role in our private pension system and in the lives of approximately 44 million workers, retirees and beneficiaries. These individuals are promised a determinable benefit under the pension plan for the duration of their years. The amount of the benefit as well as the long-term financial security for these workers depends, in large part, on the interest rate used to calculate both the funding of the promised benefit and the total benefit payable as a lump sum distribution at retirement.

On April 30th, the Subcommittee on Select Revenue Measures held a hearing to consider available options for a permanent replacement of the 30-year Treasury rate. At this hearing, the Administration, through the Treasury Department, recommended that the current temporary provision enacted in 2002 for 2 years be extended for another 2 years. The general response was well, we want a little more long-term and we are pleased that the Administration has made some proposals. There is little disagreement that the current interest rate used in calculating the level of funding needed for promised benefits under the plan is no longer an appropriate measure. I look forward to having the opportunity this afternoon to talk with Mr. Fisher and the other panel on many of these issues. I will ask that the rest of my statement through unanimous consent be submitted for the record. I yield all the rest of my time to my colleague Mr. Pomeroy.

[The opening statement of Ms. Tubbs Jones follows:]

Opening Statement of The Honorable Stephanie Tubbs Jones, a Representative in Congress from the State of Ohio

Today I am pleased to join my colleagues, Chairman Jim McCrery of the Select Revenue Measures Subcommittee, Chairman Sam Johnson, and Ranking Member, Robert Andrews, of the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, for this joint hearing.

We are all in agreement that the focus of this hearing, the Administration's proposal for a permanent replacement of the 30-year Treasury rate, is a very important issue for every Member of Congress and millions of American workers. The ultimate resolution of this issue will have a major effect on millions of American workers, not just for a day or a week, but for the duration of their retirement years.

Defined benefit plans, the intended target of the proposal before us, play a very important role in our private pension system, and in the lives of approximately 44 million workers, retirees, and beneficiaries. These individuals are promised a determinable benefit under the pension plan for the duration of their retirement years. The amount of the benefit, as well as the long-term financial security for these workers, depend in large part on the interest rate used to calculate both the funding of the promised benefit and the total benefit payable as a lump sum distribution at retirement.

On April 30, 2003, the Select Revenue Measures Subcommittee held a hearing to consider available options for a permanent replacement of the 30-year Treasury rate. At this hearing, the Administration, through the Department of the Treasury, recommended that the current temporary provision, enacted in 2002 for two years, be extended for another two years.

The general response from most of our Members to this recommendation was frustration. Many of us are keenly aware of the important role this issue plays in the long-term financial planning of corporate plan sponsors and the retirement security for millions of Americans.

There is little disagreement that the current interest rate used in calculating the level of funding needed for promised benefits under the plan is no longer an appropriate measure. In addition, we have heard from many plan sponsors and representatives of employee groups who have expressed strong opposition to a temporary extension of the existing formula.

The level of uncertainty that such an approach could cause for plan sponsors could lead to the ultimate demise of our defined benefit plan system. This is an undesirable outcome for the 44 million workers and their families who are currently served by our defined benefit system.

It is clear that we have a difficult task ahead of us as we seek to develop a proposal that would balance the competing interests of plan sponsors and financial security for millions of American workers, beneficiaries and retirees who have earned a pension under these plans.

I would like to thank the Administration for responding to the concerns of our Members and presenting us with a proposal for discussion today. I look forward to working with my colleagues and the Administration as we seek to develop a balanced and reasonable solution to this important issue.

Mr. POMEROY. I thank the gentlelady very much for yielding and appreciate the Chair's indulgence. I am going to be called to another meeting that I have to attend. I want to put on the record that I believe we have to approach the issue of reserving for pension funds consistent with the broad bipartisan goal of making certain we have defined benefits as an active presence in the employer benefit marketplace that we define our response to the existing funding formula problem in a way that will not place additional and significant pressure on the freezing or termination of defined benefit plans.

Indeed, we ought to have as a goal increasing defined benefit plans not bringing them to an end. To that end, I believe that new reserving strategies that are unknown, that are not defined, that are highly complex that raise a distinct prospect of substantial near term funding liabilities to the employers all place pressure against continuing defined benefit pension plans and will significantly impact corporate strategies in this regard.

I am a former insurance commissioner, and I care a lot about solvency. So, I don't think anybody ought to confuse what we are talking about as we look for strategies that work. We want solvent pension plans, no question about it. We don't want to take such a conservative approach with coming up with a funding formula that we inadvertently place significant pressure on the employer community to freeze or terminate their defined benefit plan. In the end that doesn't do anybody good, most particularly the workers that need their pensions. In that regard, I look forward to this hearing. It is an extremely important one, Mr. Chairman. I will have some questions to submit in writing in the event that I don't have an opportunity to ask them in this hearing.

Chairman JOHNSON. Without objection, so ordered. Thank both of you for your comments. I want to welcome our witnesses, both Chairman McCrery and I welcome you to our hearing. The Honorable Peter Fisher is our first witness, and the Honorable Ann Combs is our second. We are glad to have both of these esteemed people from the Administration. Peter Fisher was confirmed by the U.S. Senate as Under Secretary for Domestic Finance on August 3, 2001. Prior to joining the Treasury Department, Mr. Fisher was Executive Vice President of the Federal Reserve Bank of New York and manager of the system Open Market Account for the Open Market Committee overseeing all domestic open market and foreign exchange operations and the provision of account services to foreign central banks. Mr. Fisher earned his Juris Doctor (JD) degree from Harvard and his Bachelor of Arts (BA) from Harvard college.

Ann Combs is the Assistant Secretary of Labor for Employment Benefits Security and was confirmed on May 9, 2001. Before her appointment, Ms. Combs was Vice President and Chief Counsel, Retirement and Pension Issues for the American Counsel of Life Insurers. She also was a principal at the William M. Mercer firm and served on the Advisory Council on Social Security. During the Reagan and prior Bush Administration she spent 6 years as Deputy Assistant Secretary for the Employee Benefits Security Administration. A graduate of the University of Notre Dame, Ms. Combs holds a JD from George Washington.

I remind Members that we will be asking questions after both witnesses have testified and ask Members to be mindful of the 5 minute rule. I believe that both of you are familiar with that 5 minute rule as well. Mr. Fisher, you may proceed.

STATEMENT OF THE HONORABLE PETER R. FISHER, UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Chairman Johnson, Chairman McCrery, Ranking Member Andrews, and other Members of the Committee. Ann Combs and I are pleased to be here to present the Administration's proposals for accurately measuring the liabilities of defined benefit pensions. I ask that my written testimony be made part of the record. Let me briefly summarize my testimony. Our shared goal is to improve the retirement security for workers and retirees by strengthening the financial help of the voluntary defined benefit system. To do this, we must ultimately undertake comprehensive reform.

Americans are rightly demanding increased accuracy and transparency in corporate accounting. The Administration believes that America's pension beneficiaries are every bit as entitled to timely and accurate accounting and disclosure as are America's shareholders. The Administration's proposals released on July 8th represent a first step in this direction. The current rules that specify minimum funding requirements have not served us well. Sponsors today face burdensome and volatile funding contributions, and many plans are not adequately funded.

Current rules provide one set of funding requirements under one set of measures, but if a plan slips below certain funding levels on those measures, the regime switches to a different measure and more stringent funding rules. This leads to volatility and uncertainty in funding requirements. The Administration would like to work with Congress over the next few months to develop proposals to reform funding rules to reduce this volatility in funding contributions while also moving to better funded plans over time. If we can reach agreement on more accurate measures and fix the funding rules, we would then like to consider adjustments to the tax deductibility of pension contributions to encourage sponsors to make contributions in good times as well as bad.

From the Administration's point of view, the predicate for doing any of this is accurate measurement of current pension liabilities.

Chairman McCrery, in testimony before your Subcommittee in April, I identified three issues that need to be addressed to create a permanent replacement for the 30-year Treasury. Our proposal addresses each of those. First, pension discount rates should be designed to ensure that liabilities reflect the timing of future benefit payments. Using a single long-term corporate interest rate to discount all pension liabilities will mask the underfunding of many pension plans and put other plans at risk. The Administration proposes that benefit payments made in future years be discounted to today's dollars using discount rates taken from a corporate yield curve. Liabilities would be computing using interest rates for specific years to discount benefit payments due to be made in each year. The Administration proposes a 5-year transition, beginning with use of long-term corporate rates in years 1 and 2 for all plans.

Everyone understands that if you go to a bank to purchase a certificate of deposit (CD), you will receive a different interest rate for a different maturity CD. A 1-year rate for a 1-year CD, a 5-year rate for a 5-year CD, and a 10-year rate for a 10-year CD. If in measuring the present value of the bank's liabilities for those different CDs, the bank used only a 10-year rate, it would significantly understate its liabilities for the short-term CDs. The same math holds true for pension liabilities.

Second, to produce an accurate measure of liabilities, pension discount rates should be based on current financial conditions. The current rules for smoothing discount rates by using a 4-year average leads to less accuracy and to greater volatility in funding. The Administration proposes a 5-year transition from 4 years smoothing to 90 days smoothing. This will eliminate the impact of day-to-day market volatility while providing an appropriately current measure of interest rates.

Third, in order to fairly treat workers of all ages, we should use the same yield curve to value age appropriate lump sum payments in a consistent and neutral manner. The Administration proposes that after a 5-year phase in, the same yield curve used to manage pension liabilities should be used to measure lump sum payments. Everyone recognizes that the Administration's proposal provides the most accurate measure of liabilities. Criticism of our proposal are off the mark. Pension rules appear to be the only part of our financial system that do not use the standard techniques in calculating present values.

Moreover, discounting all liabilities using a single long-term corporate rate will lead to systematic underfunding of pensions in plans with predominantly older workers. We think that older workers have the same right to well-funded pensions that younger workers have and that they should not be disadvantaged by the use of an inaccurate discount rate methodology. As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen Americans' retirement security by producing accurate measure of pension liability. I look forward to answering your questions and to working with both of your Committees to achieve this goal.

[The prepared statement of Mr. Fisher follows:]

Statement of The Honorable Peter R. Fisher, Under Secretary for Domestic Finance, U.S. Department of the Treasury

Chairman McCrery, Chairman Johnson, Ranking Member McNulty, Ranking Member Andrews, and Committee members, Labor Assistant Secretary Ann Combs and I are pleased to present to you the Administration's proposals for strengthening the long-term health of the defined benefit pension system and making pension benefits more secure for America's working men and women.

To begin, we must be clear on our objective: we all want to improve the retirement security for the nation's workers and retirees by strengthening the financial health of the voluntary defined benefit system that they rely upon. Current estimates suggest that pension plans in aggregate are underfunded by more than $300 billion. To achieve our objective, pension funding must improve. That will not happen until the existing pension funding rules are fixed. Over the next few months, the Administration would like to work with Congress to analyze the existing funding rules and develop additional proposals to improve and strengthen them.

Making Americans' pensions more secure is a big job that will require comprehensive reform of the pension system. The Administration proposal that we released on July 8 is the necessary first step in the reform process but it is only the first step. Before I outline that proposal in detail, I would like to summarize briefly the case for comprehensive reform and list some of the topics that we believe reform should address.

Reform Issues

Americans have a broadly shared interest in adequate funding of employer-provided defined benefit pensions. Without adequate funding, the retirement income of America's workers will be insecure. This by itself is a powerful reason to pursue improvements in our pension system.

At the same time, we must remember that the defined benefit pension system is a voluntary system. Firms offer defined benefit pensions to their workers as an employee benefit, as a form of compensation. Our pension rules should thus be structured in ways that encourage, rather than discourage, employer participation.

Key aspects of the current system frustrate participating employers while also failing to produce adequate funding. We thus have multiple incentives to improve our pension system, and to thus better ensure both the availability and the viability of worker pensions. We owe it to the nation's workers, retirees, and companies to roll up our sleeves and to create a system that more clearly and effectively funds pension benefits. Major areas that require our prompt attention include:

1. *Funding Rules*

Our complicated system of funding rules has been constructed, in part, to dampen the volatility of firms' funding contributions. Yet current rules fail to do so. After years of making few or no contributions at all, many firms are facing precipitous increases in their annual funding requirements. This outcome is frustrating to business and it has failed to provide adequate funding for workers and retirees.Improvements to funding rules should mitigate volatility, foster more consistent contributions, and increase flexibility for firms to fund up their plans in good times. Specific issues in the funding rules that need to be examined include:

a. Volatility Caused by the Minimum Funding Backstop. The current minimum funding backstop, known as the deficit reduction contribution, causes minimum contributions of underfunded plans to be excessively volatile from year to year.
b. Funding Target. The existing funding target is based on current liability, a measure with no clear or consistent meaning. We will seek to develop a better target.
c. Contribution Deductibility. Together, minimum funding rules and limits on maximum deductible contributions require sponsors to manage their funds within a narrow range. Raising the limits on deductible contributions would allow sponsors to build larger surpluses to provide a better cushion for bad times.
d. Asset Measurement. Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set appropriately if both assets and liabilities measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility.
e. Credit Balances. If a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest can be credited against future required contributions. These credit balances—mere accounting entries—do not fall in value even if the assets that back them lose value. Credit balances allow seriously underfunded plans to avoid making contributions, often for years, and contribute to funding volatility.
2f. Benefit Amortization. The amortization period for new benefits can be up to 30 years long. This may be excessive. We will also look at other statutorily defined amortization periods.

2. *Actuarial Assumptions*

We also intend to examine how the application of actuarial assumptions in the current funding rules may contribute to funding volatility and to inaccurate measurement of pension liabilities. For example, companies do not want to be surprised to find they have inadequately funded their plans because the mortality tables used in the funding rules are outdated or because those rules fail to account for lump sum payments. We will examine:

a. Mortality Tables. In order to ensure that liabilities are measured accurately mortality estimates need to be made from the most up to date and accurate tables available. The Treasury will be examining the tables currently in use over the next few months and determine, after inviting public comment, whether they should be replaced.
b. Retirement Assumptions. Retirement assumptions made by plan actuaries need to reflect the actual retirement behavior of those covered by the plan.
c. Lump Sums. Liability computations for minimum funding purposes need to include reasonable estimates of expected future lump sum withdrawals that are determined by methodologies that are broadly consistent with other estimates of plan obligations.

3. *Other Issues*

Three other issues also deserve review:

a. Extent of Benefit Coverage. It may be advisable to limit or eliminate guarantees of certain benefits that typically are not funded, such as shutdown benefits.
b. Multi-employer Plan Problems. Multi-employer plans operate under a different set of rules than single-employer plans. Despite these regulatory differences, the same principles of accuracy and transparency should apply to multi-employer plans, and we will be reviewing the best ways to accomplish this.
c. PBGC Premiums. PBGC's premium structure should be re-examined to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

Although comprehensive reform needs prompt attention, as I testified before your Subcommittee in April, Chairman McCrery, the necessary first step is to develop a more precise measurement of pension liabilities. Fixing the pension funding rules won't help unless we give our immediate attention to ensuring that we are accurately measuring the pension liabilities on which those rules rely.

As I described in detail at the April hearing, our immediate task is replacing the 30-year Treasury rate used in measuring pension liabilities for minimum funding purposes.

I think that we all agree that any permanent change in pension discounting rules should not contribute to future pension plan underfunding. In making the recommendations that I am about to describe, the Administration is seeking to measure accurately pension liabilities, in order to provide the necessary foundation for reform of the funding rules, which then will help ensure that pension promises made are pension promises kept.

We face two near-term concerns that must be addressed in getting to a permanent replacement of the current discount rate.

First, firms that sponsor defined benefit plans already are budgeting their pension contributions for the next several years. Near-term changes to the current rules that would increase pension contributions above current expectations could disrupt these firms' existing short-term plans.

Second, many underfunded plans are already facing sharp increases in their required pension funding contributions. Thus, while we must ultimately ensure that liabilities are measured accurately and that firms appropriately fund the pension promises they have made, an abrupt change from the current system could do more short-term harm than good by triggering plan freezes or terminations.

The Importance of the Discount Rate in Pension Funding

To determine minimum required funding contributions, a plan sponsor must compute the present value of the plan participants' accrued future benefit payments, which is known as the plan's current liability. The present value of a benefit payment due during a particular future year is calculated by applying a discount factor to the dollar amount of that payment. This discount factor converts the dollar value of the future payment to today's dollars. Current liability is simply the sum of all these discounted future payments.

Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. Liability estimates that are too low will lead to plan underfunding, potentially undermining benefit security. Pension plan liability estimates that are too high lead to higher than necessary minimum contributions, reducing the likelihood that sponsors will continue to operate defined benefit plans.

Computing pension liabilities is basically a two step process. In the first step, the plan actuary estimates the payments that will be made to retirees each year in the future. The pension plan's actuary makes these estimates based on the plan's terms, and estimates of how long current employees will work before retirement and receive benefits in retirement. Estimating the future stream of payments involves considerable judgment on the part of the actuary.

Step two, converting the value of future payments to today's dollars, is, by comparison, simple and rather mechanical. To convert payments in a future year to present dollars, the estimated payments are simply adjusted by the appropriate discount rate. Although some discounting schemes use the same discount rate to compute the present value of payments for all future years, it is no more difficult to compute the present value using different discount rates for each future year.

Choosing the right rate is the key to accurate pension discounting. The wrong rate leads to inaccurate estimates of liabilities that can be either too high or too low.

Therefore, the primary goal of the Administration's proposal to replace the 30-year Treasury rate can be summed up in one word: accuracy. Without first accurately measuring a plan's pension liabilities, the minimum funding rules cannot ensure that the firm is setting aside sufficient funds to make good on its pension promises to its workers. Accurate liability measures also provide a firm's investors with valuable information about the pension contributions that will be made from the firm's earnings. Accurate liability measures allow workers and retirees to monitor the health of their pension plans. Finally, accurate liability measures allow the PBGC as pension insurer to better monitor the health of the overall pension system.

Pension Discounting under Current Law

Since 1987, federal law has required that pension liabilities that determine minimum pension contributions be computed using the interest rate on the 30-year Treasury bond. Liabilities computed using this discount rate have become less accurate over time, as financial conditions have changed. In the late 1980s, inflation was at higher levels than today. As the inflation rate has declined, the term structure of interest rates has changed. Congress recognized this and in 2002 passed legislation that temporarily changed the discount rate to provide funding relief to plan sponsors. This temporary fix expires at the end of this year.

In my April testimony, I put forward an Administration proposal that would have extended this fix for two additional years while the Treasury Department developed a permanent replacement discount rate. However, dissatisfaction with the continued use of the 30-year rate, even on an interim basis, was expressed by many members of Congress and pension sponsors. Your Committees asked the Administration to go back and return with a permanent proposal that we could support and, after two months of intense work, we are now pleased to present it today.

The Administration's Proposal for Accurately Measuring Pension Liabilities

In my April testimony, I explained why the Administration believes that corporate bond rates, not Treasury rates, should be the basis for the pension discount methodology. I also identified three key issues that needed to be addressed in selecting a permanent replacement for the 30-year Treasury rate: the time structure of a pension plan's future benefit payments; the appropriateness of smoothing the discount rate; and the appropriate relationship between the discount rate and the computation of lump sum payments.

The proposal I will now set forth deals with each of these issues.

1. Pension discount rates should be based on market determined interest rates for similar obligations.

The terms of pension contracts are not market determined because pensions are not bought and sold in an open market and pension sponsors do not compete with one another for participants. However, group annuity contracts, which are very similar to employer sponsored pensions, *are* sold in a competitive market by insurance companies. Group annuity contracts obligate the seller to provide a stream of annual cash payments, in exchange for a competitively priced premium, to individuals covered by the policy. We take the view, as Congress has in the past, that pension discount rates should reflect the risk embodied in assets held by insurance companies to make group annuity payments. These assets consist largely of bonds issued by firms with high credit ratings. Furthermore, the insurance companies issuing the group annuity contracts also have high credit ratings.

Therefore, the Administration proposes that the new pension discount rate be based upon an index of interest rates on high-grade corporate bonds.

2. Pension discount rates should be designed to ensure that liabilities reflect the timing of future benefit payments.

Each pension plan has a unique schedule of future benefit payments—or cash flow profile—that depends on the characteristics of the workforce covered by the plan. These characteristics include the percent of participants that are retired, the age of current workers covered by the plan, the percent receiving lump sums and whether the covered workforce has been growing or shrinking over time. Plans with more retirees and older workers, more lump sum payments, and shrinking workforces will make a higher percentage of their pension payments in the near future, while plans with younger workers, fewer retirees, fewer lump sums, and growing workforces will make a higher percentage of payments in later years.

One approach to liability computation applies the same discount rate to all future payments regardless of when they occur. This approach produces inaccurate liability estimates because it ignores a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment or the loan. If a consumer goes to a bank to buy a Certificate of Deposit, he will expect to receive a higher rate on a five-year CD than on a one-year CD. Likewise, that same consumer who borrows money to buy a house expects to pay a higher interest rate for a 30-year than a 15-year mortgage.

Pension discount rates must recognize this simple financial reality. Pension payments due next year should be discounted at a different, and typically lower, rate than payments due 20 years from now. Why is this important? Pension plans covering mostly retired workers that use a 20-year interest rate to discount all their benefit payments will understate their true liabilities. This will lead to plan underfunding that could undermine retiree pension security, especially for workers who are nearing retirement age. Proper matching of interest rates to payment schedules cannot be accomplished using any single discount rate.

Computing liabilities by matching interest rates on zero-coupon bonds that mature on the same date that benefit payments are due is not complicated. Once expected pension cash flows are calculated by the actuary it is no more difficult to discount benefit payments on a spreadsheet with an array of different interest rates than it is if only one discount rate is used.

It is also important to understand that the discount rate used does not change the actual obligation—the liability is what it is. Choosing the proper discount rate gives us an accurate measure in today's dollars of future benefit payments; it does not change those payments. But if we don't measure that value properly today, plans may not have sufficient funds set aside in the future to make good on those pension promises.

The Administration proposes that benefit payments made in future years be discounted to today's dollars using discount rates taken from a corporate bond yield curve (a table or graph that illustrates the interest rates on bonds that mature at different dates in the future). Liabilities would be computed by using interest rates on bonds that mature on a specific date in the future to discount benefit payments due to be made that same year.

Furthermore, implementation of the yield curve would be phased in over five years. The phase-in would start with the use of a single long-term corporate bond rate as recommended in HR 1776 (proposed by Congressmen Portman and Cardin) for the first two years. In the third year a phase-in to the appropriate yield curve discount rate would begin. The yield curve would be fully applicable by the fifth year.[1]

This phase-in period would provide some short term funding relief for sponsors, but achieve the desired level of accuracy at the end of five years.

3. Pension discount rates should be based on current financial conditions.

Pension liability computations should reflect the current market value of future benefit payments—this is a key component of accuracy. Plan sponsors and investors are interested in the current value of liabilities in order to determine the demands pension liabilities will place on the company's future earnings. Workers and retirees are interested in the current value of liabilities so that they can determine whether their plans are adequately funded.

Some argue that discount rates should be averaged (smoothed) over long periods of time. Under current law they are smoothed over four years. Such smoothing is intended to reduce the volatility of liability measures and helps make contribution requirements more predictable. Unfortunately current smoothing rules reduce the accuracy of liability measures while failing to achieve stability in annual contributions. Smoothing can mask changes in pension plan solvency of which workers and retirees should be aware. As I mentioned earlier, we would like to work with Congress to identify permanent reforms of the funding rules that would reduce volatility in annual contributions, without the corollary effect of reducing measurement accuracy.

[1] In years 1 and 2 pension liabilities for minimum funding purposes would be computed using a discount rate that falls within a corridor of between 90 and 105 percent of a 4 year weighted average of the interest rate on a long-term highly-rated corporate bond. In years 3 and 4, pension liabilities would be an average of that calculated using a long-term corporate rate and that using a yield curve. In year 3, the corporate rate would receive a ⅔ weight and the yield curve a ⅓ weight. In year 4 the weights would be switched and in year five liabilities would be computed using the yield curve.

The Administration proposes to decrease smoothing gradually during the 5-year phase-in. In years one and two, four year smoothing is maintained. Smoothing is reduced in years three and four and finally, in year five, set a 90-day moving average to eliminate the impact of day-to-day market volatility. This will provide an appropriately current measure of interest rates.

4. Pension discount rates should apply to annuities and lump sum payments in a consistent and neutral manner.

Retirees and departing workers in some plans can opt to receive a single payment for their pension benefits rather than regular payments over their lifetimes. The value of these so-called lump sum payments is the present value of the worker's expected retirement annuity. Using different discount rates for annuities and lump sums creates an economic incentive for choosing one form of payment over the other.

The Administration proposes that the yield curve used to measure pension liabilities also be used to compute lump sum payments so as to reflect accurately the life expectancy of retirees in the amounts that they will receive. In order to minimize the disruption of plans of workers who will receive benefits in the immediate future, lump sums would be computed using the 30-year Treasury rate as under current law in years one and two. In the third year a phase-in to the appropriate yield curve discount rate would begin. By the fifth year lump sums will be computed using the yield curve.

Workers receiving lump sums, especially those in their 50's, 60's and older, would be better off under the Administration proposal than under an alternative that would compute lump sums using a single long term corporate interest rate. Workers electing lump sums at relatively younger ages would have a higher proportion of their future payments discounted at long-term interest rates than workers retiring at relatively older ages. This is appropriate given the different time frames over which they had been expecting to receive their benefits. While moving from the 30-year Treasury rate to any corporate bond based rate will result in lower lump sum payments for younger workers who leave their jobs, under the yield curve approach older workers closer to retirement age will be little affected by the change.

However, some workers who will soon be leaving their jobs have been anticipating taking their pension benefits in the form of a lump sum with the expectation that those benefits would be computed using the 30-year Treasury rate. Computing lump sums using the yield curve rather than the 30-year Treasury rate may result in lower lump sum payments for those who leave at a young age. The Administration proposal is for the benefits of younger and older workers alike to be consistently and accurately valued, whether a lump sum or a traditional annuity benefit.

Concluding Observations

In closing I would like to make a few general observations about the Administration's proposed permanent discount rate for pension liabilities.

Because discounting pension payments using a yield curve is already considered a best practice in financial accounting, large sponsors are almost certainly making these computations now or know how to make them.[2] Sponsors certainly know what their expected future pension cash flows are.

The mechanics of discounting future pension cash flows are in fact quite simple. This is true whether one uses a single rate to discount all payments or uses different rates to discount payments made in each year. Such calculations, which can be done with a simple spreadsheet, should not pose serious problems even for small plans let alone plans sponsored by large, financially sophisticated firms.

Yield curves used to discount pension benefit payments have been available for a number of years. One example of such a pension yield curve is the one developed by Salomon Brothers in 1994 for the Securities and Exchange Commission. Monthly Salomon Brothers yield curves dating back to January 2002 can be found on the Society of Actuaries web site at http://www.actuarial library.org.[3] We envision that the Treasury Department would adopt a similar methodology. Using this widely accepted approach, we would develop and publish a yield curve reflecting interest rates for high-quality zero-coupon call adjusted corporate bonds of varying maturities.

The adjustments that we would anticipate making—through a rulemaking process subject to public comment—would only be to reflect accurately the time structure of the yield curve. The procedure we envision would involve two types of adjust-

[2] See Financial Accounting Standard 87.

[3] This address opens a window to the Society's site search engine. To see discount curve examples simply type Salomon Brothers Pension Discount Curve into the query window.

ments: (1) standardizing the corporate rates as zero coupon, call adjusted rates; and (2) extrapolating the shape of the corporate yield curve using the shape of the Treasury yield curve because of the thinness of the market for corporate bonds of some durations, especially long-term bonds. The yield curve rates would not be adjusted to reflect expenses, mortality or any other actuarial or administrative concerns. The high-grade corporate rates used to construct the curve will only be adjusted so that they accurately reflect the time structure of benefit payments.

As I mentioned, the Treasury would undertake this process using a formal notice and comment rulemaking process to ensure market transparency and to incorporate input from all interested parties in final development of the yield curve. Although the groundwork is well established, we certainly plan to work with all stakeholders to finalize the methodological details of the ultimate yield curve.

While we believe that important near-term considerations warrant beginning the transition by allowing plans to use a long-term corporate bond index for the first two years, staying there would result in greater underfunding over time than we face today. Such an outcome would be counterproductive and harmful, and would certainly move the defined benefit system in the wrong direction. Most importantly, it would put workers' pensions at greater risk.

Some have alleged that there would be adverse macroeconomic consequences to using a yield curve. Such critics allege that the economy would suffer because the resulting increased pension contributions would deplete funds from the economy. That argument is, we submit, incorrect. A firm's pension contributions are invested by the plan for the future benefit of the plan's participants. Those contributions go right back into the economy as savings. They are not withdrawn from the economy. Pension funds are a significant source of capital investment in our economy—investment that creates jobs and growth. And again, an accurate measurement of liabilities is necessary to ensure appropriate funding of pension promises to America's workers.

The macroeconomic effect we should be worried about is that which would result if plan sponsors failed to fund the pension promises that America's workers are depending upon for their retirement security. This is why the Administration is urging that pension liabilities be accurately measured and why we intend to return before your Committees with further recommendations to fix the pension funding rules. Only if our pension liabilities are accurately measured will we be able to have an informed dialogue about such comprehensive reforms.

Some have alleged that this proposal would place sponsors of plans with older workforces at a disadvantage by requiring them to put more money into their plans than they would under alternative proposals. The fact of the matter is that more money is needed in those plans to ensure that older workers receive the benefits they have earned through decades of hard work. These obligations of employers to our older workers exist whether our measurement system accurately recognizes them or not. We think that older workers have the same right to well funded pensions that younger workers have and that they should not be systematically disadvantaged by the funding rules.

Finally, we should also not overlook other positive consequences of more accurate pension liability measures. We live in an era when Americans are rightly demanding increased accuracy and transparency in corporate accounting. Surely this is the standard we should pursue for the pension systems on which Americans' workers depend. Uncertainty about the size of pension liabilities has negative effects on sponsor stock prices. Increased accuracy of pension liability measurement will greatly reduce that uncertainty when such measures become available to the public under the enhanced disclosure measures that will be discussed by Assistant Secretary Combs. We see all of these recommendations as working together to clarify our pension funding challenges, better informing the public, employers and policy makers about what must be done to ensure adequate worker retirement security.

As I stated at the outset, the Administration's permanent discount rate replacement proposal is designed to strengthen American's retirement security by producing accurate measures of pension liabilities. And accurate measurement is the essential first step in ensuring that pension promises made are pension promises kept.

Chairman JOHNSON. Thank you, sir. Ms. Combs, you may begin your testimony.

STATEMENT OF THE HONORABLE ANN L. COMBS, ASSISTANT SECRETARY FOR EMPLOYEE BENEFITS SECURITY, U.S. DEPARTMENT OF LABOR

Ms. COMBS. Thank you, Mr. Chairman, Chairman McCrery, Ranking Member Andrews, and other Members of the Committee. I appreciate the opportunity to be here today before both Committees to discuss the Administration's proposals to strengthen the defined benefit system. We share both Committee's goals that defined benefit plans are an important source of retirement. We want to make this system stronger. The Administration's immediate plan represents the first crucial step toward more comprehensive reform.

As Under Secretary Fisher has described, the first component of our proposal to provide for more accurate measurement of pension liabilities, I will now describe the remaining two components to improve transparency of pension plan funding and to protect workers and retirees and pension plans that pose the most severe risk of terminating without sufficient assets to pay benefits. The ERISA currently includes a number of reporting and disclosure provisions, yet their exists a void when it comes to the disclosure sure of pension funding information.

The current disclosure rules have major shortcomings in both the timeliness and the quality of the information made public. Current disclosures do not satisfy workers, retirees or the financial markets need to know the funding status of pension plans. The Administration believes that workers should have the facts about their pension fund plans funded status. Transparency will both empower workers to plan for the future and encourage employers to responsibly fund their plans. We recommend three specific reforms at this time and look forward to working with both Committees to develop additional improvement in the future.

First the Administration proposes that all companies disclose the value of their defined benefit pension plan assets and liabilities on both the current liability and the termination liability basis in their summary annual reports. This straightforward reform proposal would provide all workers in defined benefit plans with this vital information. It would encourage responsible funding and strengthen the defined benefit pension plan system.

Second, we propose making available to workers certain financial data that companies already provide to the PBGC if their pension plans have more than $50 million in underfunding. This information, which is known as 4010 data, includes the most recent financial information about a pension plan's funding status. Under current law, PBGC cannot share this information with workers retirees or the financial markets.

Finally, we would require companies to annually disclose their liabilities as measured by the proposed yield curve as that rate is phased in. Such disclosure will give workers and the financial markets a more accurate expectation of a plan's funding obligations and status under the new liability measure. Let me turn now to the Administration's proposals to safeguard against further deterioration in pension underfunding. Existing ERISA rules do not prevent planned sponsors from making pension promises that they cannot afford, nor require them to fund adequately the promises they make.

The ultimate result is shattered worker expectations, strains on the PBGC insurance system, and pressure on the remaining more responsible PBGC premium payers. The Administration believes we must stop the most sought financially challenged companies with severely underfunded plans for making new pension promises that they cannot afford. Our proposal would only affect the most extreme examples of vulnerable plan sponsors, but it would help workers plan for their retirements based on realistic benefit promises and minimize PBCG's exposure. Our safeguards would only affect companies with below investment grade credit ratings whose plans are less than 50 percent funded on a termination basis. These plans would be frozen and could not increase benefits or pay lump sums in excess of $5,000 unless the plan sponsor contributes cash or provides security to fully fund the accruals, the benefit improvements or the lump sums.

These same safeguards would extend to pension plans that are less than 50 percent funded and whose sponsors are in bankruptcy. For those plans that are in bankruptcy, PBCG guarantee limits would also be frozen. This proposal, as I said, is targeted at only those plans that are most likely to terminate without sufficient assets. Based on preliminary PBGC data, only 57 plans are sponsored by firms with below investment grade credit ratings and are funded at or below the 50-percent threshold level. These plans have total liabilities of $34 billion in assets of just $14 billion leaving $20 billion in exposure.

The President's plan we described today addresses only the most pressing issues we urge Congress to address in the very short-term. There are a host of extremely important issues where we must work together if we are to restore workers and retirees' confidence in their retirement plans and bring a measure of stability to the defined benefit pension system.

The Bush Administration's goal was to get plans on a path toward better funding, to reduce volatility in contributions and to encourage companies to fund their pension plans at levels sufficient to weather tough economic times. By strengthening the rules to restore certainty in funding and to prevent abuses, we will make more attractive for plan sponsors to retain their defined benefit plans. This concludes my remarks, and I would ask that my full remarks be included in the record and I would be happy to take questions.

[The prepared statement of Ms. Combs follows:]

Statement of The Honorable Ann L. Combs, Assistant Secretary for Employee Benefits Security, U.S. Department of Labor

Introductory Remarks

Good afternoon Chairman Johnson, Ranking Member Andrews, Chairman McCrery, Ranking Member McNulty, and Members of both Subcommittees. Thank you for inviting me to discuss the Administration's proposal to improve the accuracy and transparency of pension information, as well as the funding of defined benefit pension plans. I am proud to represent the Department of Labor and the Employee Benefits Security Administration (EBSA), who work to protect American workers, retirees and their families and to support the growth and stability of our private pension and health benefits system.

As you know, EBSA interprets and enforces Title I of the Employee Retirement Income Security Act (ERISA), which addresses the conduct of fiduciaries who are responsible for operating pension and health benefit plans. EBSA is charged with administering and enforcing this statute together with the Treasury Department, which is generally responsible for the tax provisions in ERISA, and the Pension Benefit Guaranty Corporation (PBGC), which provides insurance to protect the retirement benefits of participants in defined benefit plans when the corporate plan sponsor fails and the plan is inadequately funded.

ERISA governs approximately 730,000 private pension plans and six million private health and welfare plans. These plans cover approximately 150 million workers and their dependents and hold assets of more than $4 trillion. There are approximately 33,000 defined benefit plans guaranteed by the PBGC covering 44 million workers and retirees.

As my colleague from the Department of Treasury stated, the financial health of the voluntary defined benefit plan system is under significant pressure. Over the past two years, a significant number of large companies with highly underfunded defined benefit plans have failed, resulting in PBGC taking over their pension plan assets and liabilities. In FY 2002, the PBGC took a tremendous hit to its single-employer insurance program, going from a surplus of $7.7 billion to a deficit of $3.6 billion—a loss of $11.3 billion in just one year. The loss is more than five times larger than any previous one-year loss in the agency's 28-year history. Moreover, based on PBGC's midyear unofficial unaudited financial report, the deficit has grown to approximately $5.4 billion.

Why is the emergence of this deficit of such concern to Congress and the Administration? The PBGC's alarming deficit reflects a fundamental imbalance in the system that has occurred not only because of historically low interest rates and a loss in asset values, but also because of structural weaknesses that allow certain plans to continue to over-promise benefits as they descend into insolvency. Defined benefit pension plans play an important role in retirement security and should remain a viable option for those companies and workers who desire them. Unless we correct the problems leading to underfunding, healthy plan sponsors who subsidize unhealthy companies through their premium payments will continue to drop out of the defined benefit system leaving only the sick plans behind—a classic insurance death spiral. The result will be fewer workers with defined benefit plans and a greater level of risk for those workers who remain covered.

When underfunded plans terminate without sufficient assets to pay promised benefits, many workers' and retirees' expectations are shattered, and, after a lifetime of work, they must change their retirement plans to reflect harsh realities. The Administration developed its reform package with these workers and retirees in mind. We can prevent similar situations in the future, while keeping a viable defined benefit system, if we act to improve and stabilize plan funding. If corporate plan sponsors and their counterparts in organized labor pursue reforms that leave pensions underfunded, then workers will remain vulnerable to losing some of the pension benefits they were promised.

PBGC and the Departments of Labor, Treasury, and Commerce have developed a reform package in an effort to improve pension security for workers and retirees by strengthening the financial health of the defined benefit system. Under Secretary Fisher has already discussed the Administration's proposed discount rate for measuring pension plan liabilities, and I will now discuss the final two components of the Administration's proposal regarding improved transparency of pension plan information and increased safeguards against pension underfunding.

Transparency of Pension Plan Information

It's been said that sunlight is the best antiseptic. One of the hallmarks of the Bush Administration has been an aggressive agenda to strengthen our economy by improving transparency and moving corporate and union financial disclosures out of the shadows.

America's system of free enterprise, with all of its risks and rewards, is a great strength of our country and a model for the world. The fundamentals of a free market require clear rules and confidence in the accuracy of information if we are to achieve President Bush's goal for "America to become an ownership society, a society where a lifetime of work becomes a retirement of independence." Ownership involves risks, but that risk must be based on shared, accurate and timely information.

As major investors, defined benefit pension plans sponsored by American companies play a critical role in our national economy and in the lives of American workers, retirees and their families. The financial health of these plans must be transparent and fully disclosed to their "owners"—the workers and their families who rely on promised benefits for a secure and dignified retirement.

As columnist George Will said, a properly functioning free market system "requires transparency, meaning a sufficient stream of information—a torrent, really—of reliable information about the condition and conduct of corporations." The same holds true for their pension plans.

While ERISA includes a number of reporting and disclosure provisions that provide workers with information about their employee benefits, there exists a void in the law when it comes to the disclosure of pension funding information to workers. For example, although workers have a right to expect that their pension plans are well funded and that their retirement benefits are secure, they are typically unaware that the law sets only minimum funding obligations. Workers often do not learn the true extent of their plan's underfunded status until it terminates, frustrating workers' expectations of receiving promised benefits—and a secure retirement.

Current Law

The most basic disclosure requirement of a pension's funding status to workers under current law is the summary annual report (SAR). ERISA[1] and DOL regulations require pension plans to furnish a SAR to all workers and retirees. The Form 5500, used by private sector pension and other employee benefit plans to annually report information to the Department of Labor, the Internal Revenue Service and the PBGC regarding the financial condition, investments and operations of their plans, is due seven months after the end of the plan year with a potential extension of an additional two and a half months. Following the filing deadline of the Form 5500, pension plan sponsors must then distribute the SAR within two months.

Corporate pension plan sponsors must use a SAR to disclose certain basic financial information from the Form 5500 including the pension plan's net asset value, expenses, income, contributions, and gains or losses. A pension plan's net asset value is calculated based on the market value of assets minus the plan's expenses incurred during the plan year. The SAR must also include the current value of a defined benefit plan's assets as a percentage of its current liability if the percentage is less than 70 percent.

The "current liability" is a plan's liability as of today, it is intended to reflect a pension plan's liability assuming the employer's plan will continue indefinitely. It does not reflect a plan's "termination liability"—the cost to a company of terminating its pension plan by paying lump-sums and purchasing annuities in the private market that reflect the benefits workers have earned. This is an important distinction to workers concerned about the pension plan terminating.

A second disclosure in current law is Section 4011 of ERISA that requires underfunded single-employer pension plans to send notices of their underfunding to workers and retirees. This notice must describe the plan's funding status and the limits of PBGC's guarantee. Generally, plans that are less than 90% funded on a current liability basis are required to distribute Section 4011 notices, although there are several significant exceptions.

In 2002, preliminary data indicates that less than ten percent of plans gave notices as required by Section 4011 out of a universe of approximately 33,000 defined benefit pension plans. The notice must be furnished no later than two months after the filing deadline for the Form 5500 for the previous plan year, and may accompany the SAR if it's in a separate document.

ERISA requires some pension plans to provide a third type of disclosure under Section 4010, but these disclosures are not provided nor available to workers or the public. Section 4010 requires corporate pension plan sponsors with more than $50 million in aggregate plan underfunding to file annual financial and actuarial information with the PBGC. Filings are required no later than 105 days after the close of the filer's fiscal year, although PBGC may grant waivers and extensions.

Pension plan sponsors who file Section 4010 data with the PBGC must provide identification, financial, and actuarial information. Plan sponsors must provide financial information including the company's audited financial statement. Sponsors also are required to provide actuarial information that includes the market value of their pension plan's assets, the value of the benefit liabilities on a termination basis, and a summary of the plan provisions for eligibility and benefits.

In 2002, approximately 270 plan sponsors reported plan information with the PBGC under Section 4010. So far in 2003, approximately 350 plan sponsors have filed Section 4010 data. Prior to 2002, the largest number of Section 4010 filings received by the PBGC in any calendar year was less than 100. Obviously many

[1] ERISA Section 104(b)(3).

more pension plans are triggering the $50 million level of underfunding that requires their sponsors to file Section 4010 data.

Shortcomings of Current Law

The current disclosure rules have major shortcomings in both the timeliness and quality of the information made available. Current disclosures do not satisfy workers', shareholders' or the financial markets' desire to understand the funding status of pension plans and the consequences of underfunding. The true measure of plan assets and liabilities is not transparent to workers, retirees, investors, or creditors.

Pension plan sponsors calculate numerous measures of their pension plan liabilities, including current liability and actuarial liability, plus several methods of calculating each of them. Among all of these potentially confusing measures, only the termination liability comes close to expressing the pension plan's true ability to pay promised benefits if it terminates, and the potential exposure to PBGC.

Less than ten percent of pension plans sent workers and retirees notices of severe underfunding in 2002 as required by Section 4011. Although many plans are facing unprecedented levels of underfunding, the complicated rules and exceptions [2] in current law relieve most plans of the obligation to send Section 4011 notices.

Even when plans are required to send Section 4011 notices, workers do not receive sufficient information regarding the consequences of plan termination. The information required does not reflect the plan's underfunding on a termination basis: exactly the kind of information workers would most need if their pension plan is severely underfunded.

The Bush Administration's Proposal

In formulating our transparency proposal, the Administration recognized that workers and retirees deserve a better understanding of the financial condition of their pension plans, that required disclosures should realistically reflect funding of the pension plan on both a current and termination liability basis, and that better transparency will encourage companies to appropriately fund their plans.

Disclose Plan Assets and Liabilities on a Termination Basis

The Administration proposes that all companies disclose the value of their defined benefit pension plan assets and liabilities on both a current liability and termination liability basis in their SAR. This straightforward reform proposal is sweeping and effective in that it would require all plans to report this information. Informed participants will better understand their plan's funding status and plan accordingly. They can also serve as effective advocates encouraging their employers to better fund their plans.

Disclose Funding Status of Severely Underfunded Plans

The Administration proposes that certain financial data already collected by the PBGC under Section 4010 from companies sponsoring pension plans with more than $50 million of underfunding should be made public. We propose that the available information be limited to the underfunded plan's market value of assets, termination liability and termination funding ratios. Much of the information disclosed in the Section 4010 data, such as sensitive corporate financial information, should not be made public.

As described earlier, Section 4010 liability data is more timely and of better quality than what is publicly available under current law. Year-end Section 4010 figures generally are required to be filed no later than 105 days after the close of the plan sponsor's fiscal year. This information on the pension plans with the largest unfunded liabilities, currently restricted to the PBGC, is critical to workers, the financial markets and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Disclose Liabilities Based on Duration-Matched Yield Curve

The Administration also proposes that companies annually disclose their liabilities as measured by the proposed yield curve described by Under Secretary Fisher before the rate is fully phased in for funding purposes. Such disclosure will give

[2] For example, many plans do not send out Section 4011 notices because the requirement does not apply to a plan if (1) the funded current liability percentage for the plan year is at least 80 percent, and (2) such percentage for each of the two immediately preceding plan years (or each of the second and third years preceding plan years) is at least 90 percent. Notices are further not required under Section 4011 where plans do not pay a PBGC variable rate premium in a given plan year.

workers and the financial markets more accurate expectations of a plan's funding obligations and status under the new liability measure.

Safeguards Against Deterioration in Pension Underfunding

Before ERISA's enactment in 1974, thousands of workers lost their pensions because their companies failed to adequately fund the benefits they promised. In enacting ERISA, Congress set out to ensure that companies would safely set aside enough money in advance to secure workers' pensions. Unfortunately, current law does not achieve that goal.

ERISA's funding rules aim to provide both security for workers and flexibility for plan sponsors. However, existing rules do not prevent corporate sponsors from making pension promises that they cannot afford, nor require them to fund adequately the promises they make.

Current Law

Current law establishes funding rules for pension plans, including rules that prohibit underfunded plans from increasing benefits. Under provisions in both the Internal Revenue Code and ERISA that apply to large plans,[3] if a pension plan's funding ratio falls below 60 percent of current liability, a company generally may not provide a benefit increase greater than $10 million unless the increase is immediately funded or security is provided to fully fund the improvement. A company sponsoring a plan with a funding ratio above 60 percent on a current liability basis may have a much lower funding ratio on a termination liability basis, exposing its workers to the risk of receiving reduced pension benefits from the PBGC if the plan terminates.

Shortcomings in Current Law

Recent history demonstrates that some companies under financial duress make pension promises that in all probability will never be funded. These promises further strain the funding status of a plan and jeopardize the retirement security of unsuspecting workers when the plan ultimately terminates and is taken over by the PBGC. Furthermore, unfunded benefit increases undermine the financial integrity of the pension benefit guaranty system. Other defined benefit plan sponsors who fund their plans far more responsibly ultimately pay whatever unfunded benefits are guaranteed by PBGC through their premiums.

The current system includes a "moral hazard." A company facing financial ruin has the perverse incentive to underfund its defined benefit pension plan while continuing to promise additional pension benefits. The company, its employees, and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan then by other plan sponsors in the form of PBGC guarantees. Financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they must eventually fund them.

The Bush Administration's Proposal

The Administration believes we must ensure that companies, especially those in difficult financial straits, make benefit promises they can afford and fund the pension promises they make. As we develop more comprehensive funding reforms, we must stop the most financially challenged companies with severely underfunded plans from making pension promises that they cannot afford. Our proposal would only affect the most extreme examples of vulnerable plan sponsors, would help workers plan their retirements based on realistic benefit promises, and would minimize PBGC losses.

The proposal that we provide to you now would require companies with below investment grade credit ratings whose plans are less than 50 percent funded on a termination basis to immediately fully fund or secure any new benefit improvements, benefit accruals or lump sum distributions. Benefit improvements would be prohibited unless the firm contributes cash or provides security to fully fund the improvement. The plan would be frozen, i.e., accruals (increases resulting from additional service, age or salary growth) would be prohibited unless the firm contributes cash or provides security to fully fund the additional liability.

To prevent erosion of such plans' funding, lump sum payouts of more than $5,000 would be prohibited unless fully funded or secured. Allowing workers to take lump sum distributions from severely underfunded plans, especially those sponsored by financially strapped companies, allows the first workers who request the distribu-

[3] Code section 401(a)(29) and ERISA section 307.

tions to drain the plan, often leaving the majority of workers to receive reduced payments from the PBGC when the plan terminates.

The Administration also proposes to extend the above safeguards to plans of corporate plan sponsors that file for bankruptcy with plans funded at less than 50 percent of termination liability. Furthermore, we recommend that PBGC's guaranty limits be frozen as of the date of the bankruptcy filing. This freeze would avoid another perverse incentive.

Based on PBGC's preliminary 2003 data covering 90 percent of filing companies with plans that are underfunded by $50 million or more (the Section 4010 filers described above), only 57 plans sponsored by firms with below investment grade credit ratings are funded at or below 50 percent on a termination basis. Their liabilities total $34 billion but their assets total just $14 billion, leaving $20 billion of liabilities unfunded.

Another 32 plans sponsored by unrated firms (which may be above or below investment grade) are funded at or below 50 percent. These plans report liabilities of $10 billion and assets of $4 billion. Still another 68 plans are sponsored by firms in bankruptcy. These plans report liabilities of $28 billion and assets of $14 billion.

In Under Secretary Fisher's testimony, he listed several of the areas under review for a package of more comprehensive reforms of the pension system. The issue of unfunded benefit increases by underfunded plans is prominent among those issues with which we have significant concerns. Our immediate proposal to restrict benefit increases by the most vulnerable plans and financially troubled companies does not represent everything that must be addressed in this area, but is merely a first step to "stop the bleeding" in cases that obviously undermine the financial integrity of the pension system.

Other Issues

The President's plan we've described today addresses only the most pressing issues Congress must address in the very short term. As Under Secretary Fisher noted, there are a host of other, extremely important, issues where we must work together to address if we are to restore workers' and retirees' confidence in their retirement plans and introduce a long-overdue measure of stability to the defined benefit pension system.

Defined benefit plans are intended to provide a secure source of retirement income that lasts a lifetime. Recent volatility in the stock market has reminded workers of the value of such plans where corporate plan sponsors bear investment risk. As our aging workforce begins to prepare for retirement and think about how to manage its savings wisely, there is a renewed interest in guaranteed annuity payouts that last a lifetime.

If we do nothing but paper over the problems facing defined benefit plans and the companies and unions that sponsor them, we will ill-serve America's workers threatened by unfunded benefits and potentially broken promises.

The Bush Administration is continuing to work on further proposals to strengthen the defined benefit system. Our goal is to get plans on a path toward better funding, to reduce harmful volatility in contributions, to encourage companies to set funds aside during good times so that when we enter another tough economic patch, sufficient assets have been set aside to weather the storm. We must keep in mind that this is a voluntary system. By strengthening the rules to restore certainty in funding and prevent abuses, we will make it more attractive for plan sponsors to retain their defined benefit plans.

We are reviewing revised funding targets to protect workers from the threat of losing promised benefits because their plan terminates without sufficient assets to meet liabilities. We are reviewing revised funding rules that would better reflect the risk that a plan will terminate without sufficient assets. We are also reviewing the actuarial assumptions that underlie required funding contributions, including appropriate mortality tables, realistic retirement ages, and the frequency of lump sum payouts. And we intend to address some of the glaring gaps in the law, for example those that allow severely underfunded plans to continue to enjoy funding holidays because they are carrying credit balances based on outdated asset values.

We need to keep improving the system's transparency, achieving better and more-timely disclosures to workers, retirees, and the financial markets. We also should re-examine the PBGC's premium structure to see whether it can better reflect the risk posed by various plans to the pension system as a whole.

As we have reviewed both the method of discounting and the need for comprehensive reforms, we have simultaneously recognized the need for some transition relief to employers in our early stages of economic recovery, while improving funding standards over the long term. But we cannot allow the acknowledged need to reduce some near-term pressures to delay comprehensive reforms for too long lest we put more workers' retirement security at risk.

Finally, we need to look at the challenges facing the multiemployer pension system as well—which has the same needs for transparency, accuracy of measurement, and adequate funding standards.

The reform package we unveiled last week was intended to respond to an immediate need to replace the expiring discount rate used to value plan liabilities. The limited nature of the package we are presenting at this time should in no way be construed as a signal that these are the only issues that should be addressed. The Administration is not only ready but eager to work with Congress to develop a broad package of reforms that will strengthen the defined benefit system and protect the workers and retirees who rely on them for their retirement security.

Thank you and I will answer any questions the committees may have.

Chairman JOHNSON. Without objection so ordered, and your remarks will be entered. Mr. Fisher, the Administration's proposal calls for an elimination of smoothing techniques. Can you explain why using unsmoothed interest rates instead of using a 4-year weighted average of interest rate would be preferable and why would this increase plan volatility?

Mr. FISHER. We all agree on the need to reduce the volatility and uncertainty that corporate sponsors face in funding levels that change from year to year. We believe that volatility is actually a consequence of the interaction of the smoothing rule with the current funding rules. The current funding rules oscillate between one set of measures, as I said, and another set of measures when plans fall below specified target levels. The smoothing rules which provide for a 4-year smoothing of interest rates actually induce corporate sponsors to wait and see whether interest rates will change.

Instead of adjusting to changes in the measurement of their liability as interest rates move, the 4-year smoothing masks the underfunding that is developing in their plans, which lets them in the hope that interest rates will come back they then wait and wait and wait and then get caught in the bind of our current funding rules. So, we actually believe that a 90-day smoothing will provide sponsors with the right incentives to stay on top of their funding requirements year by year and quarter by quarter without waiting to see whether they can grow their way out of an underfunding problem that begins to develop.

Chairman JOHNSON. What you are saying is a more accurate assessment?

Mr. FISHER. That is right. It will give us a much more accurate assessment.

Chairman JOHNSON. Ms. Combs, do you think participants in a multi employer pension plan should be able to learn about funding status of their plans in a manner similar to the way participants in single employer plans do under your proposal?

Ms. COMBS. We do, Mr. Chairman. I think it is important for all workers, regardless—it is important for all workers, regardless of the form in which they receive benefits, to have accurate information and to have transparency. We would be happy to work with you to develop appropriate disclosures for multi employer pension plans. They are structured somewhat differently and we would be happy to work with you to get appropriate disclosure.

Chairman JOHNSON. Shouldn't we require that type of policy for them as well as the other?

Ms. COMBS. As I said, I think transparency is always important and we would be happy to work with you on that, yes.

Chairman JOHNSON. You don't think it ought to be part of this program?

Ms. COMBS. I think if targeted disclosure on the funding status could be added to this program, because it is very analogous to what we are proposing for single employers. Larger issues facing the multi-employer plan, I think, deserve separate attention.

Chairman JOHNSON. Thank you. Mr. Fisher, would a yield curve be used to determine a company's variable rate premium payment and what effects would that have on the PBGC?

Mr. FISHER. Applying the curve to the variable rate payment was not part of our July 8th proposal. As my written testimony summarized, we think all of the premium rules should be part of the comprehensive form which we are prepared to work with both these Committees on immediately. We just did not see it as part of the immediate, immediate task of adjusting the rate. We think review of the premium rules should be part of comprehensive reform, but it was not part of our proposal on July 8th.

Chairman JOHNSON. Do you intend to revise your program at all?

Mr. FISHER. We had—we have not yet determined to revise our proposal. We look forward to this hearing to hearing from the Committee on your views.

Chairman JOHNSON. Thank you, sir. I will reserve the rest of my time and Chairman McCrery, you are recognized for whatever comments you wish to make and/or questions you might have.

Chairman MCCRERY. Thank you Mr. Chairman. Along those lines, Mr. Fisher, there are some who have suggested that until we know the full package of reforms from the Treasury Department, that we shouldn't move forward with a permanent replacement of the 30-year Treasury rate. Setting that aside for a moment, feel free to comment on that, I hope we can all agree that the worst thing we can do is not to act at all, in other words, to allow this current increase in the rate to expire this year with no replacement either on a temporary or a permanent basis; would you agree with that?

Mr. FISHER. Yes, we certainly agree on the urgency of acting. I assume from my testimony, you are aware we believe that the predicate for comprehensive reform is accurate measurement. Accurate measurement can't wait until a later day. We have to begin with accurate measurement in order to be able to do comprehensive reform.

Chairman MCCRERY. While I agree with you, it is just possible that Congress can't agree on what the most accurate measurement is right now forever and ever. If that is the case, I would hope that the Administration would urge us to, at the very least enact a temporary solution to the current interest rate problem or discount rate problem.

Mr. FISHER. That would not be hard for the Administration, given that a temporary solution was our original proposal 2 months ago before your Committee.

Chairman MCCRERY. Before I go further, I want to commend the Administration for coming forward with a permanent solution. I do hope that the Congress can agree and move forward with a permanent solution. That is my first choice, but I wanted to make sure we established here that the worst thing we can do is to do nothing, either on a temporary or a permanent basis.

As you pointed out in your last appearance before my Subcommittee, the Administration included three specific proposals, and now you are saying that you are exploring additional reforms. Could you give us an idea of the types, or at least the subject areas of the reforms you are considering now?

Mr. FISHER. Certainly, sir. My written testimony spells out in some length the laundry list, and let me highlight the ones that I think are of particular interest. The schizophrenic nature of our funding rules, as I have said in my oral remarks, have not served us well. We have the rather soft assumptions of the actuaries providing generous inputs to the funding rules, which, if companies fall below specified levels they move to a completely different measurement system coming up with much harsher funding requirements. We would like to find something of a middle course.

Now, finding a new set of funding rules we think is possible, and we have been working on this for many months. It requires a lot of work and simulations of the impact on the company plans to find a way to provide for a much smoother path that would get companies improving their funding and not the precipitous jump that is a consequence of the DRC. We think that is probably front and center.

Let me be clear, as I said in my written testimony, the Treasury Department will begin next month the review of the mortality tables. We will invite public comment on that. We think that is another part of improving accuracy. We would like if we can get to greater accuracy, get to a fundamental rethinking of the funding rules that will avoid the sharp changes in funding levels, but move companies to better levels over time. Then as I said, we would like to look at the deductibility of contributions to encourage companies in good times as well as bad. In addition, the topics covered by Assistant Secretary Combs on benefit limitation and disclosure and PBGC's framework for premiums, we think all of that should be addressed as part of comprehensive reform.

Chairman MCCRERY. Those are certainly matters of some import and some concern to corporations in this country that have pensions, but I gather that despite the import of those issues, you do not think it is premature to move forward with a permanent replacement with a 30-year Treasury note as a discount rate absent those—completing those kinds of studies and reforms?

Mr. FISHER. That is correct, because we think any reform would include the use of the most accurate measure we could think of.

Chairman MCCRERY. Mr. Chairman, my time has expired. I have some more questions, either for a second round or to submit in writing at a later time. Thank you.

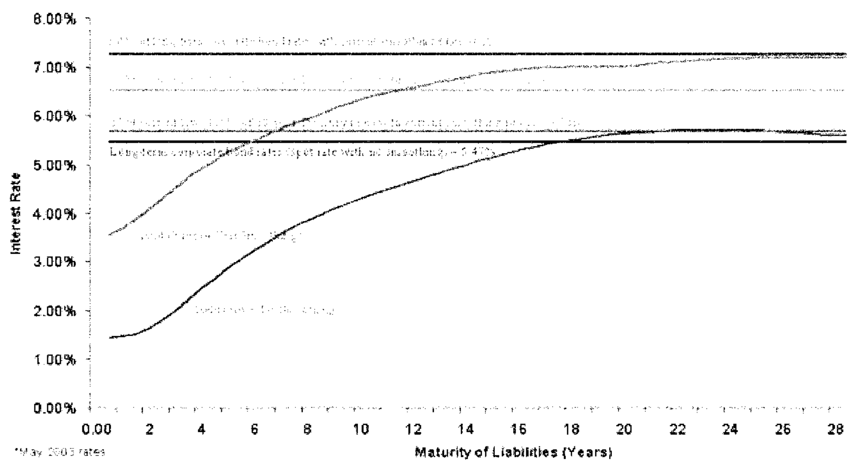
Chairman JOHNSON. Thank you, Chairman McCrery. Mr. Andrews, you are recognized.

Mr. ANDREWS. I would like to thank both witnesses for their testimony. As usual, it was very thorough and comprehensive. We appreciate it.

Mr. Fisher, I want to ask you, under what circumstances might the yield curve flatten sooner than you think it is going to flatten in this document that is in front of us here? Looks to me like it starts to smooth—starts to flatten out rather at about year 14. Are there circumstances where it would flatten out sooner than that?

[The chart follows:]

Under a Yield Curve Method, Liabilities Faced Sooner Would Be Discounted Less



Mr. FISHER. The chart you are looking at, it was prepared by the Treasury Department staff some days ago. It reflects a snapshot of current interest rates as of, I believe, May. That is not a forecast of rates in the future. You point to an important issue which is the risk that a yield curve inverts and then would have short rates higher than long rates.

Mr. ANDREWS. Under what circumstance might that happen?

Mr. FISHER. That would happen if the Federal Reserve was tightening interest rates as typically when short-term rates would move up to be as high or perhaps higher than long term rates.

If I could, over the last 20 years, the Treasury yield curve has inverted a total of only 14 months out of 20 years. The corporate yield curve, which we are recommending as the basis for the yield curve for measuring liabilities, was inverted for only 1 month out of the last 20 years, and at that, only a very fraction of a few basis points. So, if you use a corporate curve, it is much less likely to invert, and therefore the important issue you are driving at, which has affected pensions while Treasury rates were being used.

Mr. ANDREWS. If I could do a little more driving, so there is the possibility that there will be an inversion of the yield curve. To a layperson, and I am one, that sounds to me like I could meet a situation where the contribution I would have to make to my defined benefit plan would go up rather appreciably if I were an employer; is that correct?

Mr. FISHER. If the yield curve inverted and stayed inverted for a long period of time that could happen.

Mr. ANDREWS. My understanding is that the Administration's proposal is that after 5 years, there really would be no more smoothing. There would be a 90-day period, right? So, I don't get the benefit of the prior 3 years of averaging that in, right?

Mr. FISHER. That is correct.

Mr. ANDREWS. We can argue about the improbability. I don't claim to know how probable or improbable it is, but I sure do know that it is possible. It seems to me you got two things going here that would be inherently unstable. The first is that you are baking into the cake and writing into the law the possibility of an inversion in the yield curve. The second is that you are taking out of the law the measures that might mitigate the cost of that inversion by shrinking the smoothing period from 4 years to 90 days. Doesn't that strike you as kind of a double problem that might render a lot of employers reluctant to continue funding defined benefit plans?

Mr. FISHER. No, I don't sir, because as I explained over the last 20 years there was only 1 month of an inversion of the corporate yield curve, in which case, 90-day smoothing would have removed that.

Mr. ANDREWS. Does the yield curve move independently of the bond rate curve?

Mr. FISHER. There are occasions where corporate spreads change in relation to Treasury curves so the two curves can move independently.

Mr. ANDREWS. Generally speaking, is the yield curve more or less volatile than the bond rate curve?

Mr. FISHER. They are volatile in different ways at different times. I would actually suggest the Treasury curve is perhaps more volatile.

Mr. ANDREWS. I didn't ask about the Treasury curve. I asked about the yield curve versus the corporate bond curve. Which is more volatile?

Mr. FISHER. The yield curve of Treasury, I believe, would be more volatile than a corporate curve.

Mr. ANDREWS. Could you supplement the record with some data on that? I don't ask the question rhetorically. I ask it wanting to know. My concern here is someone who is an amateur at this subject is the introduction of some new uncertainties, new volatility in an environment where we are working hard to try and retain and expand defined benefit plans.

If I were an employer and I knew there were any significant probability I would have to make a major increase into what I put in the defined benefit plan, it would make me less likely to have one. The purpose of this, I think, is to deal with the immediate problem of this drain on corporate resources to fund present plans, but also to deal with the more intermediate and long-term problem with encouraging people to create and maintain these plans. I appreciate your thoughts on this. Thanks, Mr. Chairman.

Chairman JOHNSON. Thank you, Mr. Andrews. Ms. Tubbs Jones, do you care to question?

Ms. TUBBS JONES. I do, but I would like to yield to my colleague, Mr. Pomeroy.

Mr. POMEROY. Just to follow up a bit on the inversion. It strikes me that it is somewhat of a unique period of time where we have historically low interest rates and extremely high budget deficits creating, I think, significant prospects. We are going to have a higher short-term than long-term rate as the system adjusts going forward. I also think—I will tell you, Secretary Fisher, I find it flat out surprising that you don't think that the regimen you have advanced will strike the employer community as significantly higher, in fact onerous reserving requirements such that they might be discouraged away from maintaining support for their defined benefit plans. Have you had discussions with the employment community leading you to your conclusion?

Mr. FISHER. Yes, we have had extensive discussions.

Mr. POMEROY. The discussions I have had they told me that this is a significant departure from the kind of stable funding requirement reflective of their near and long-term liabilities and would lead them to change their view of the defined benefit plan and whether they could continue it or not. You are telling us that you don't think that this is going to be a problem?

Mr. FISHER. I am sure you will hear from them that they think it is a problem. I want to be clear, we believe that pensions should be funded to their actual liabilities. We don't think the defined benefit system can survive if we only do it by putting our head in the sand about the actual measure of liability.

Mr. POMEROY. The actual measure of liability will change significantly based upon the long-term—we are talking about long-term liabilities and therefore changes in the interest rates, earnings on the pension funds will significantly change their funding status at any given time. Are you suggesting that as changes occur due to, for example, investment return falloff that we are experiencing in recent times, all that needs to be made up in the near term by advanced funding by employers.

Mr. FISHER. No. We are not suggesting that. We think, though, in reducing the volatility of contributions that employers face, we need to focus on the mechanism that produces it. Those are the funding rules combined with the 4-year smoothing which we think discourages companies from taking action to fund their plans when circumstances begin to change.

Mr. POMEROY. I believe to the contrary. That moving to a 90-day smoothing, you add an additional element. In addition to the yield curve volatility, you add yet another point of volatility that is going to have me as a chief executive officer saying, I simply don't know what my outside liability exposure is here year to year. I cannot satisfy shareholder demand for quarterly returns when I don't know what I am going to have to be taking off of the bottom line for pension funding. We are going to have to move away from defined benefit plans. There is just simply too much volatility and uncertainty. I believe that is precisely what you are moving forward.

I would say in addition—I am taking Ms. Tubbs Jones' time—I am very surprised that in light of the strong feedback we gave you to come back with a plan, the plan you come with, you come 1 week in advance of this hearing shortly before we intend to take legislative action on this matter with something as—as new and significantly different as this yield curve proposal.

This is an idea with some conceptual legitimacy, but an awful lot of very practical questions about implementation, timing, what it means in terms of expense—compliance, expense and complexity. I simply think we are hard-pressed to come to grips with all of this in 2 years, expecting employers to take a 2-year fix on corporate bond index, moving to a totally unknown environment thereafter has hardly displaced the confusion and the concern about whether that relative to pension funding presently has, in fact, made it a good deal worse.

Secretary Combs, I would say the third feature you got relative to restricting all additional new liabilities of pension plans that fall in that category, those covering 57 plans, about $34 billion in potential liabilities, would that mean essentially you would statutorily impose a freeze, and there could be no new accrual of pension benefits, including to the worker continuing their tenure at those places of employment?

Ms. COMBS. That is correct. We would freeze those plans. No new accruals, no benefit improvements.

Mr. POMEROY. This is absolutely wild to me. We are trying to stop the freezing of pension plans and you are going to statutorily impose them across the board.

Ms. COMBS. The company—if they are willing to put the cash into pay for those additional accruals, if they are willing to provide security, if they can put the cash on the barrel head to pay for the benefit improvement, to pay for the lump sums, that is fine, but they are not going to extend their credit and keep digging the hole deeper. These are severely underfunded plans where people are really at risk of having their plan terminated without sufficient assets and facing much cutbacks in terms of their already accrued benefits under the PBGC or their expectations of early retirement subsidies that they may age into.

So, we are just saying stop the bleeding if you are in this bad shape unless you have the cash or you can come up with the security to fund it. Then if you can get out of that situation and get better funded, or if your credit rating recovers, then your accruals will kick back in.

Mr. POMEROY. The information I have from the marketplace is that your worker protections are going to protect the workers' right of their pensions.

Chairman JOHNSON. The gentleman's time has expired, Mr. McKeon, do you wish to question?

Mr. MCKEON. I would like to thank you both for being here and jumping into this non-controversial subject that we have before us. Mr. Fisher, can you please explain how using a yield curve will affect large companies with many defined benefit plans? Will this dramatically increase the cost to employers?

Mr. FISHER. Sir, I believe that large plan sponsors, sophisticated companies, will find that it takes a matter of minutes, perhaps hours, but not days to adjust to the yield curve approach. Large plan sponsors have sophisticated financial operations. They have actuaries who will understand this material better than either you or I will. Today, every major pension plan has a schedule of the payments they expect to make in future years. The actuaries develop that for them. That is the complicated piece of the puzzle. The current regime, the current statute says they are to take 120 percent of the 30-year Treasury rate to discount each of those annual streams of payments. So, they plug in one rate for each of those annual outflows.

What we are suggesting is that after we would publish a yield curve such as today we publish the 30-year Treasury rate for them to use, they would simply plug in the year appropriate rate for their—to fill in and calculate their liability. Now for plans with older workforces, this is a vital reform that we need to make sure that the plans are adequately funded to be there for the workers' retirement benefits. If we don't take account of the time structure of the benefits, then large companies with older workforces won't be funding to the prudent level.

Mr. MCKEON. Thank you very much. Secretary Combs, many people have said that requiring plan sponsors to reflect liabilities on their yearly financial statements is inconsistent with the long-term nature of pension obligations. Is there a possibility that this could unnecessarily create panic among stockholders participants as well as volatility in the company's stock price?

Ms. COMBS. Our proposal is to have all plans report on an annual basis to their workers and public at large two numbers: What is their liability on an ongoing basis and what would be their liability if they terminated the plan and had to go out and purchase annuities in the market tomorrow. I don't think that should cause panic. I think that would give people a more realistic picture of what are the possibilities. If their company sponsoring the plan is in weak financial condition, that should factor into their planning for their own retirement, and perhaps into the kind of benefit increases that they may be involved in negotiating if it is a bargained plan.

I think that sunshine and information is a good thing. I don't think it will panic people. I think companies can explain this in a very rational way, and I think markets are figuring this out. It is getting filtered in through the financial markets, and I think workers deserve the same information that analysts on Wall Street are already calculating and figuring out. So, I don't think it should panic people. I think it can be done in a way where it is providing more information, and you will have better informed workers and retirees who will be able to make realistic planning for there own retirement.

Mr. MCKEON. Thank you very much. I yield back, Mr. Chairman.

Chairman JOHNSON. Thank you. Mr. Ryan, do you care to question? Mr. Brady, do you care to question? Mr. Foley, do you care to question? We already asked him. Ms. Blackburn, do you care to question? How about Mr. Portman? I bet he will. Mr. Portman you are recognized for 5 minutes.

Mr. PORTMAN. I thought you would never get here, Mr. Chairman. Thank you. I thank my colleagues. First of all, I am glad you are here, Mr. Fisher and Ms. Combs, and I think it is a very important discussion we are having. I am struck by some of the discussion here about volatility.

Let me just start by saying, this is a very fragile economy. This is a very difficult area in which to legislate. We are talking about billions of dollars which will have a major impact on our economy, major impact on jobs clearly, major impact on workers and their retirement quality of life; and I think we need to tread very carefully. One of the issues that comes up time and time again and has over the last 7 or 8 years, as we have legislated more aggressively on pensions—Mr. Andrews talked about it, Mr. Pomeroy talked about it—is the issue of predictability and certainty and its impact on people's decisions as to whether to have defined benefit plans and, indeed, whether to have pensions at all.

I just don't get it. How you can say that having a 90-day averaging will lead to less volatility, as compared with, say, a 1-year averaging even under your yield curve or certainly under a 4-year averaging scenario. I would hope that as we get into this process further, we would look more carefully at that issue on volatility and certainty and predictability, because I do think that that is a legitimate concern we have heard raised again and again.

If I could, though, just ask you a few questions about the plan and then ask you about some long-term reform, you keep coming back to accurate measure, and, of course, many of us believe that the long-term high-quality corporate bond index is an accurate measure. In fact, as you know, over time it has been a very conservative measure, whether you look back 75 years or 50 years or 25 years; and that is why we are not shy about promoting that as an alternative to the 30-year Treasury, which at one time was a good measurement and now is not as good a measurement—relatively low. Therefore, companies are having to put in more than they should, and it is causing a problem.

If you are so concerned about accuracy, what about the actuarial assumptions you are making? One thing we don't get into in your plan, for instance, is the mortality tables. I heard from your oral testimony—I have not seen your written testimony yet—that you would hope to address this issue in the near future. If we are going to get at accuracy, we can't just look at funding, obviously. We need to look at not just age, but also blue collar, white collar, other mortality issues.

The American Academy has come forward with some proposals. What is your proposal on that, and wouldn't that be something to address along with, as Chairman McCrery suggested, some of these contribution discount rate issues?

Mr. FISHER. On the mortality table issues, we plan next—in the month of August to invite public comment on all aspects of the mortality tables. We just don't want to take one piece at a time, the blue collar issue or someone else's issue, so we will invite public comment on every aspect of updating the mortality tables to try to get to the issue of accuracy. We couldn't agree more.

Mr. PORTMAN. So——

Mr. FISHER. We don't have a proposal now. We want to hear from everyone who has an interest as stakeholder in this process, or an expert, to give us their best advice on what we should do.

Mr. PORTMAN. Well, so do we, and I am encouraged by that. My question, I guess, is, don't you see a link between what we are talking about in terms of what the discount rate ought to be and mortality tables if you are talking about coming up with the most accurate measure?

Mr. FISHER. The two issues both go to accuracy. What we have before us——

Mr. PORTMAN. You could have a younger workforce and that force could be all white collar workers. You could have an older workforce of blue collar and vice versa. Under the Administration's proposal do you have an interest rate to determine the variable premium obligation, the PBGC's for variable premium obligation? Do you have an interest rate proposal for those?

Mr. FISHER. No. As I mentioned, that was not part of our July 8th proposal.

Mr. PORTMAN. Okay. So, that is not—is that something you plan to come up with in the short term, longer term, mid-term?

Mr. FISHER. That would be part of the comprehensive reform we would look at. I would like to be clear about the mortality tables. That is something that we can fix by regulatory change, does not require congressional action, where the interest rate does.

Mr. PORTMAN. You could, and you could have over the last few years, since the 2001 report. With regard to the cash balance plans, what is your proposal for a cash balance, which obviously is something which is growing; more and more employers are turning to cash balance? Does the yield curve also apply to cash balance plans, and how does that work with the cash balance plans?

Mr. FISHER. The yield curve would apply to the liability measurement for cash balance plans as it would for any defined benefit plan. Now, the issues of moment with respect to cash balance plans are not in the measure of the liability, but in the conversion and in the other estimations. The Treasury Department is working—we have two different efforts under way to clarify prior rules the Treasury Department has issued to try to address those issues on conversions. Our announcement of the yield curve doesn't relate to those issues.

Mr. PORTMAN. When would you expect to have that? Is that a several-week, several-month——

Mr. FISHER. Well, we are hoping to have that promptly.

Mr. PORTMAN. You have listed a number of other issues in your testimony and then some I have taken from your oral testimony today. We talked about the premium obligations, we talked about the DRCs. Do you expect to come up with a smoother path on DRCs? Is that something—I know it is not in your proposal now. I think that is an important aspect of the volatility we talked about.

Mr. FISHER. Absolutely.

Mr. PORTMAN. We talked about mortality; retirement assumptions, of course, would be part of that as well. What are your retirement assumption plans? Do you expect to come back with something on that, short term, as well?

Mr. FISHER. Yes. We want to work on comprehensive reform. We look for your input and suggestions.

Mr. PORTMAN. The notion of not allowing companies to put more aside during better times, which is—in 2001 we began a process of helping somewhat on that front. I would like to be—personally I think that is very important. We need to be more aggressive on that front—certainly wish we had been back in the late nineties, going into 2000.

You said earlier you wouldn't do that until you did other things with regard to funding. Why is that? Why wouldn't we go ahead and allow companies to set aside more now during good times?

Mr. FISHER. We would like to get to an accurate measure of pension funding.

Mr. PORTMAN. All of us would.

Mr. FISHER. Yes. Then on the basis of that, we may look again at what we think the appropriate percentage funding level is to target.

Mr. PORTMAN. My only point is——

Chairman JOHNSON. The gentleman's time has expired.

Mr. PORTMAN. I am sorry, Mr. Chairman. That is the final question I have, and I look forward to submitting more in writing. I thank Mr. Fisher and Ms. Combs for being here. I thank the Chairman.

Chairman JOHNSON. Thank you. Ms. Tubbs Jones, do you care to question?

Ms. TUBBS JONES. I do. I would like to pick up where he left off. We only get 5 minutes, so please make your answers as short as you possibly can. I want to pick up where Mr. Portman left, about you are concerned about accurate funding. If a company is in a position to fund its pension plan right now, why doesn't it make sense to allow them to do that, even if it is above the necessary funding level?

Mr. FISHER. Well, they are allowed to do it. We are talking about the question of tax deductibility. We would like to get an accurate measure—and we all agree on what appropriate funding is—and then let companies contribute to those more accurate measures in good times as well as bad and get the deductibility.

Ms. TUBBS JONES. Surely we would all like to get to accurate measuring, but all those workers that are seated out there who are worried about whether they are going to ever get any money, want to get it while the company has some money. They don't want to be in a position, when the company doesn't have any money, to say, okay, I can't get any. Especially under the proposal that is in Ms. Combs' testimony, it says that as we go through this transparency piece that if the company is incapable of providing the funding dollars to—can't speak to those dollars, that then the person can't get but $5,000. They may have paid in $10,000, $15,000, or $20,000, and they are sitting out there unable to get money.

So, it doesn't make a lot of sense to me, either, that even though we want to talk about accuracy, companies might not be able to put money into a funding pool to be able to support their employees. That wasn't a question, but I will ask you one now.

I recognize the merits of using a composite of corporate bonds to determine pension funding liability. I generally understand how the bond indexes are comprised. My concern comes from—as a result of my service on the Committee on Financial Services when we did all these hearings about Enron, Global Crossing and all those great companies that went kaput.

Are any of the companies, or the index that you are proposing to use for corporate bonds to gauge pension plans, how are you going to guarantee against that type of situation for all these workers out here?

Mr. FISHER. Well, we would use as many indexes as we can find of corporate bonds to create as diversified an index of a yield curve as we can, to avoid the kind of disturbance that would come off from one of the bankruptcy events. So, we share that concern.

There are indexes in the market today that attempt to do this. We would construct our own through notice and comment, and we would be very concerned and a great deal of effort would go into making sure that the index was not disturbed by the event of a single corporation.

Ms. TUBBS JONES. Let me turn to another area, Ms. Combs. I believe it is your testimony, if I can get to it correctly before I lose time—when we talk about transparency, what was the notion about why pension plans were not transparent when they first came into creation?

Ms. COMBS. Well, there is disclosure involved with pension plans, but in terms of the disclosure about funding status——

Ms. TUBBS JONES. That is the question.

Ms. COMBS. Right. I think the rules were—I think people—it goes back to the earlier question Mr. McKeon had. I think people do view their plans as an ongoing entity, and they don't—they were concerned that if they reported it on a termination basis, as well, that would alarm people. As I said before, I don't think that will alarm people. I think people need more information, not less. I think if you look——

Ms. TUBBS JONES. Okay. If you already said it, then we are out of time on that subject matter. Let's go on. Let me ask another question.

Ms. COMBS. Okay.

Ms. TUBBS JONES. I have a colleague—I come from Cleveland, Ohio, where since 2001 we have lost 57,000 jobs in the city of Cleveland alone, many of them manufacturing jobs, many of them companies who are in this dilemma about having sufficient dollars to pay to their retirees.

Have you contemplated—while we are talking about accuracy and other issues—providing some safeguard or some support for employees who do do lump sum payments, and they are under 59 years of age, the possibility of giving them a tax credit or getting away from charging them a tax penalty on taking now their pension fund, when they are in a hardship situation?

Ms. COMBS. That is—not as part of this proposal. I think——

Ms. TUBBS JONES. I know it is not part of the proposal, but as we are talking about helping out the companies, I am talking about helping out the workers. Is there something that we can do on that issue?

Ms. COMBS. Well, I think Mr. Portman and Mr. Cardin have worked hard at improving pension portability and having people roll their pension plans over. In terms of——

Ms. TUBBS JONES. I am not asking you what Mr. Portman and Mr. Cardin are doing. I am asking you, has the Administration contemplated anything you can do to assist workers in this area? You can answer, Mr. Fisher, if you choose.

Mr. FISHER. Our focus is on trying to improve funding rates over time. We think that is the best thing we can do for workers' retirement security.

Ms. TUBBS JONES. Would you then consider thinking about what you could do for workers, even though that might be your focus? Last question, could I have a list of the names of all the companies that you list, the 57 that are in trouble, the 32 that are in trouble, the names of those companies, please?

Ms. COMBS. We will work to get you as much information as we can. One of the problems is, it is based on information. We can't disclose companies' specific information under the law. It is one of the things we would like to change, but we will get you as much information as we can.

Ms. TUBBS JONES. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you. The lady's time has expired. Mr. Holt, do you care to question?

Mr. HOLT. I will save my questions for the next panel. Thank you.

Chairman JOHNSON. Okay. Mr. Cardin, do you care to question?

Mr. CARDIN. Thank you, Mr. Chairman. I will try to be very brief.

Chairman JOHNSON. Let me just advise everybody we are going to have a series of three votes, and so we will be gone at least 40 minutes. Are you capable of remaining should we have more questions, or do you all need to attend to business?

Mr. FISHER. We are at your service.

Chairman JOHNSON. Thank you, sir. Continue.

Mr. CARDIN. Mr. Chairman, I will try to be very brief. First, Secretary Fisher, I think we are making progress since the last time you appeared before our Committee. I particularly liked your recommendation for the first 2 years on the replacement rate.

Mr. FISHER. I was hoping someone would notice.

Mr. CARDIN. Right. It is this chart that we are concerned about. This is the chart on the decline of defined benefit plans over the last 15 years. In 1985, we had a 112,000 defined benefit plans in this country. We are now down to about 30,000 defined benefit plans. There are less and less every year.

We are very concerned about what we do here in Congress on whether—on funding or other provisions concerning the defined benefit plans, on what impact it is going to have on companies' freezing their plans or getting out of this business altogether, to the extent that they are permitted under ERISA, or not starting defined benefit plans.

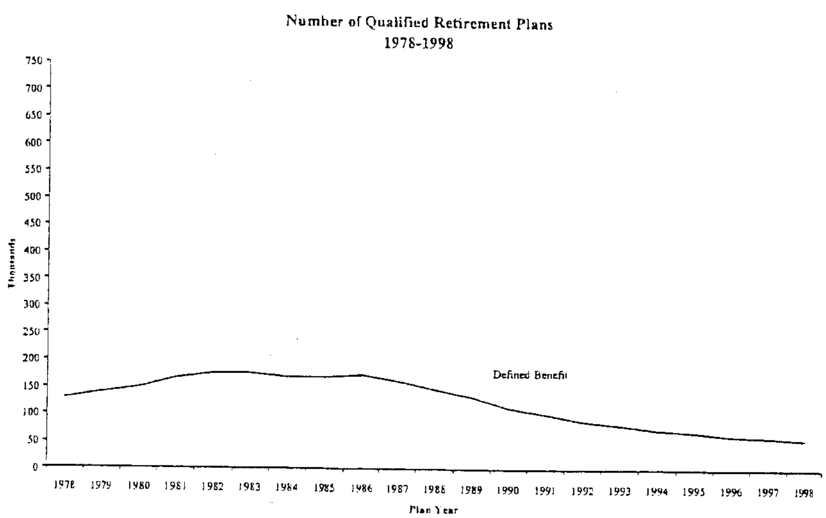
I appreciate your comments about having the most accurate measurements. We agree with you on that; we are looking for accurate measurements. I must tell you the hemorrhaging of these plans concerns all of us, because these are guaranteed benefit plans where—hedge against stock market declines. This is income security for retirees; they are very important.

I guess my question to you is sort of—follows on Mr. Portman's question. There are a lot of factors that go into the funding. We mentioned mortality earlier. I am pleased that you are now noting that we should be looking at the mortality schedules. We agree with you, by the way. If a company is using a mortality schedule that is causing them to underfund a plan, it should be adjusted; we want accurate factors.

What we have a concern about is that if you are going to make a radical change—and going to a yield curve is considered a radical change—that is something that should be really thought out very carefully in conjunction with a lot of the other suggestions that you are looking at, that you are not prepared to act on today. So, I would just encourage you to be sensitive to the impact that going to a yield curve at this particular moment could have on decisionmakers on defined benefit plans. Going to a reliable conservative corporate bond rate does help with predictability, does help with funding requirements, and does accomplish a lot of the other objectives that we are trying to in this field.

I have one quick question and that is the lump sum side. I am not exactly sure how your proposal works on lump sum distributions as far as the income rate assumptions that you are making. Could you just briefly touch on that?

[The chart follows:]



Mr. FISHER. Certainly. At the end of our transition—and I will come back and describe the transition—we would have the same corporate yield curve that we would be publishing; it would be the set of interest rates that would be used to calculate an age-appropriate lump sum for individual retirees. So, comparing a lump sum for an—imagine, to simplify the example, an 80-year-old—80 is the life expectancy of both workers. A 50-year-old, the 30-year Treasury rate would be the appropriate rate; but a 70-year-old, a 10-year rate would be the appropriate rate. Now that would be at the end of a 5-year transition. In years, we would have a transition from the current statute, which is the spot 30-year Treasury rate and move gradually from where we are now to where we would be in 5 years.

Mr. CARDIN. So, that would have some significant impact on the lump sum distributions under current policy?

Mr. FISHER. It would change it from current policy.

Mr. CARDIN. Let me yield the balance of my time to Mr. Holt.

Mr. HOLT. I thought Mr. Cardin was going to ask more explicitly about this chart and the slide in the number of defined benefit plans. Is it your intention to provide more transparent and accurate calculation methods? Or is it your intention to stop this slide away from the defined benefit plans? Or is it—do you think your proposals will have no effect one way or the other on whether people opt for the defined benefit plan or not?

Ms. COMBS. I guess we will tag team this. Our intention is to have accurate funding of pension plans so that benefit promises are kept and that people make appropriate benefit promises that they can keep and workers don't have their benefits reduced unnecessarily or unexpectedly. We think that getting to a system of—as Under Secretary Fisher mentioned, the first step—measurement is only the first step.

Then we want to get—how do we get funding rules that make sense? How do we get people on that path? There we should talk very seriously about volatility, about smoothing, about how we can gradually get people to a point where they are better funded. We believe that when plans are better funded and more reliable promises are made, then we will have an environment where we will stop losing defined benefit plans and perhaps gain some. The people who are doing a good job will have an incentive to stay in the system. Our biggest fear is that good people will leave.

Mr. HOLT. Secretary Fisher, very quickly then.

Mr. FISHER. We are concerned about healthy companies leaving the defined benefit universe, and we think if we leave the underfunding problem unaddressed and that we mask it with an inaccurate measure of reliabilities, companies that are in good shape will, through negotiations with their workers, get out of the defined benefit system.

So, the plans that you see falling off on your chart are not all unhealthy ones. Some of them are healthy ones because they wish to get away from the system to avoid being there to hold the bag if too many underfunded plans come back to roost.

Chairman JOHNSON. The time of the gentleman has expired. I would like to tell you all that our Members have agreed to put their questions in writing with the exception of one, and Mr. Levin has one question.

Mr. LEVIN. I just have a quick question.

Chairman JOHNSON. Hang on a second. Without objection, I would ask that you would be willing to answer those questions in writing as well.

Mr. FISHER. Absolutely.

Chairman JOHNSON. Mr. Levin, you are recognized.

Mr. LEVIN. Just a quickie. I am sorry I missed your testimony. Let me ask you, is it relevant when we consider these issues to contemplate the impact of our answer on the future of a company and the economy in general? Did you take that into account? So, do we need to craft pension plans that take into account the obligation to workers clearly, and also the economic future of particular conditions; is that relevant?

Mr. FISHER. Yes, we think that is a part of the calculus as we look at this.

Mr. LEVIN. You took that into account, the impact on particular companies in particular industries, in making your proposal?

Mr. FISHER. We did not look on an industry-specific basis, but clearly promoting the defined benefit universe, making this system work for all plans as part of what——

Mr. LEVIN. How about the economic health of particular industries? Did you take that into account?

Ms. COMBS. I think that is one of the reasons the first 2 years we adopt the Portman-Cardin corporate bond rate, which we think will give significant short-term funding relief to allow companies time to begin to plan to make these payments and to allow us to develop the rules.

Mr. LEVIN. You think that is sufficient?

Ms. COMBS. That is what we—yes.

Mr. LEVIN. Okay.

Chairman JOHNSON. Thank you, Mr. Levin. I thank all the Members and thank the people from the Administration. You guys did a super job. Thank you for being here with us, and you are released. We will start with the second panel when we return. The hearing stands in recess.

[Recess.]

[Additional written questions submitted by Mr. McCrery to Mr. Fisher and his responses follow:]

Questions from Representative Jim McCrery to the Honorable Peter R. Fisher

Question: If we cannot adopt the Administration's yield curve proposal, what would be your recommendation for a permanent solution for replacement of the 30-year Treasury rate?

Answer: As I stated in my testimony, making Americans' pensions more secure is a big job that will require comprehensive reform of the pension system. The Administration proposal that we released on July 8 is the necessary first step in the reform process. Pension liabilities must be accurately measured to ensure that pension plans are adequately funded to protect workers' and retirees' benefits and to ensure that minimum funding rules do not impose unnecessary financial burdens on plan sponsors. The Administration cannot accept a replacement discount rate that does not include the characteristics of the yield curve that account for the time structure of pension plans' benefit payments.

Question: In the hearing held before the Select Revenue Measures Subcommittee in April, witnesses indicated that Congress in 1987 intended the discount rate to be a proxy for the group annuity rate. Do you agree that this was Congress' intent? Two of the witnesses in April agreed that the group annuity rate is still a good target. Should it still be our goal to find a discount rate which approximates group annuity rates? If so, is there an objective measurement of the group annuity rate which is not subject to manipulation?

If insurance companies invest primarily in corporate bonds, it would seem the group annuity rate would be equal to a corporate bond index rate minus some amount for expenses and profits. I have read in a paper by the American Academy of Actuaries, for example, that a proper discount rate to reflect the group annuity rate might be a corporate bond rate minus 70 basis points. If, in the long run, our goal is an accurate discount rate, would this discrepancy between the corporate bond rate and this "group annuity rate" suggest that the blended corporate bond rate in the Portman/ Cardin bill, as a long-term solution, is too high and therefore might lead to systematic under-funding?

Answer: The terms of pension contracts are not market determined because pensions are not bought and sold in an open market and pension sponsors do not compete with one another for participants. However, group annuity contracts, which are very similar to employer sponsored pensions, are sold in a competitive market by insurance companies. Group annuity contracts obligate the seller to provide a stream of annual cash payments, in exchange for a competitively priced premium, to individuals covered by the policy. We take the view, as Congress has in the past, that pension discount rates should reflect the risk embodied in assets held by insurance companies to make group annuity payments. These assets consist largely of bonds issued by firms with high credit ratings. Furthermore, the insurance companies issuing the group annuity contracts also have high credit ratings.

Pension liabilities are the present value of future expected pension benefit payments. The adjustments that you describe have been proposed to cover certain non-liability costs of buying annuities, including insurance company profits, and adjustments to compensate for incorrect mortality measures. We do not think that pension discount rates should be adjusted to reflect group annuity expenses or any other actuarial or administrative concerns. The high-grade corporate rates used to construct the curve will only be adjusted so that they accurately reflect the time structure of benefit payments.

Question: Will there be an opportunity for public comment on the specifics of the yield curve proposal?

Answer: Yes, there will be ample opportunity for public comment on the composition of the yield curve. Treasury would publish a request for comments on how the yield curve would be determined. After receiving and reviewing public comment, the Treasury would draft a proposed regulation which would set out the specifics on how the yield curve would be determined. That proposed regulation would be subject to public comments and a public hearing would be scheduled. After those comments were received and reviewed, the Treasury would publish final regulations on how the yield curve would be determined.

Question: In the first 2 years of the Administration's plan, a blended corporate rate is utilized as the discount rate. When the yield curve is fully phased in, will the discount rate still be based on the blended corporate bond rates (with different maturities) used in the first 2 years?

Answer: No. As discussed in my testimony, implementation of the yield curve would be phased in over 5 years. The phase-in would start with the use of a single long-term corporate bond rate as recommended in HR 1776 (proposed by Congressmen Portman and Cardin) for the first 2 years. In the third year a phase-in to the appropriate yield curve discount rate would begin. The yield curve would be fully applicable by the fifth year. When the yield-curve is fully phased in, the discount rate will not in any way be based on the blended corporate bond rates (with different maturities).

More specifically, we envision that in years 1 and 2 pension liabilities for minimum funding purposes would be computed using a discount rate that falls within a corridor of between 90 and 105 percent of a 4 year weighted average of the interest rate on a long-term highly rated corporate bond. In years 3 and 4, minimum funding liabilities would be an average of liabilities calculated using a long-term corporate rate and liabilities calculated using a yield curve. In year 3, the corporate rate would receive a ⅔ weight and the yield curve a ⅓ weight. In year 4 the weights would be switched and in year five liabilities would be computed using the yield curve alone.

Question: I have heard you say in public that the "same grade" of debt would be used to determine the yield curve discount rate. What exactly do you mean?

Answer: The Administration proposes that the new pension discount rate be based upon an index of interest rates on high-grade corporate bonds. H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003 sponsored by Representatives Portman and Cardin, states that the discount rate used for pension funding purposes should be "consistent with the rate of return with respect to amounts conservatively invested in long-term corporate bonds". We interpret the phrase "conservatively invested" to mean investment in high-grade corporate bonds that have a low default risk.

Question: In testimony from the second panel, we heard that the yield curve concept has not been sufficiently developed, that it is untested. Can you please respond to those concerns?

Answer: I wholeheartedly reject the opinion that "the yield-curve concept has not been sufficiently developed, that it is untested."

Because discounting pension payments using a yield curve is already considered a best practice in financial accounting, large sponsors are almost certainly making these computations now or know how to make them.[1] Sponsors certainly know what their expected future pension cash flows are. Yield curves for use in discounting pension benefit payments have been available for a number of years. One example of such a pension yield curve is the one developed by Salomon Brothers in 1994 for the Securities and Exchange Commission. Monthly Salomon Brothers yield curves dating back to January 2002 can be found on the Society of Actuaries Web site at http://www.actuariallibrary.org/.[2]

Further, I should note that discounting using a yield curve is a standard practice in financial calculations. For example in the finance text Financial Markets, Instruments & Institutions (Second Edition), authors Anthony Santomero and David Babbel note that

"One way to value an annuity is to take the promised payment at each point in time, discount it by its respective spot rate of interest, and then sum all of the discounted cash flows."[3]

Use of a yield-curve to discount obligations is in no way new, undeveloped or untested. Rather, use of yield-curve discount rates recognizes a simple financial reality. Pension payments due next year should be discounted at a different, and typically lower, rate than payments due 20 years from now. Why is this important? Pension plans covering mostly retired workers that use a 20-year interest rate to discount all their benefit payments will understate their true liabilities. This will lead to plan underfunding that could undermine retiree pension security, especially for workers who are nearing retirement age. Proper matching of interest rates to payment schedules cannot be accomplished using any single discount rate.

Question: Will businesses be able to plan and predict pension obligations if a yield curve concept were instituted?

Answer: Pension obligations (liabilities) are the present value of expected future benefit payments. The value of these obligations is inversely related to the interest rate or rates used to discount future benefit payments, that is the obligations will be higher if interest rates are low and lower value if interest rates are high. Interest rates change over time in ways that financiers and economists cannot predict with any degree of accuracy, therefore, the value of future pension obligations cannot be predicted accurately. This is true whether benefit payments are discounted by a single long-term interest rate, as Congressmen Portman and Cardin propose, or whether they are discounted using a yield curve, as the Administration proposes.

Question: On the second panel, Mr. Steiner from Watson Wyatt Worldwide testified that rates of different duration bonds (shorter term bonds) can move independently of one another and change the shape of the yield curve, resulting in unpredictable funding requirements. How would you account for such fluctuations?

Answer: The yield curve's shape, which reflects investors expectations about the future, does change over time. This occurs because investors expectations change over time. The shape of the yield curve, like the individual interest rates that make up the yield curve change in response to countless short-term and long-term economic and financial market conditions.

[1] See Financial Accounting Standard 87.

[2] This address opens a window to the Society's site search engine. To see discount curve examples simply type Salomon Brothers Pension Discount Curve into the query window.

[3] Santomero, Anthony and David Babbel *Financial Markets, Instruments & Institutions* (Second Edition), McGraw-Hill Irwin, 2001, page 104.

The Administration's proposal directly accounts for such changes by using a yield curve rather than a single interest rate to compute pension liabilities. This approach produces accurate liability estimates because it takes into account a basic reality of financial markets: that the rate of interest earned on an investment or paid on a loan varies with the length of time of the investment or the loan.

It is important to understand that the discount rate used does not change the actual obligation—the liability is what it is. Choosing the proper discount rate gives us an accurate measure in today's dollars of future benefit payments; it does not change those payments. But if we don't measure that value properly today, plans may not have sufficient funds set aside in the future to make good on those pension promises.

Question: Will the yield curve discount rate apply to all defined pension plans regardless of size? Will smaller plans have the resources to calculate pension liabilities using the yield curve discount rate, or should Congress consider an exemption for smaller pension plans?

Answer: We do not feel that small plans should be exempt from computing liabilities in a way that reflects the time structure of their benefit payments. We believe that accounting for this time structure is essential to ensuring that all plans, large and small, are adequately funded. We hope that as we go through the rule making process small plan sponsors will find that it is simple for them to adopt the yield curve approach in computing their liabilities.

Treasury is of course ready, if the Member's wish, to devise an even simpler method for small plans to compute liabilities that still reflects the time structure of each plan's benefit payments. Such simplification of course results in reduced accuracy of the liability measure that is computed. While such a tradeoff of reduced accuracy for computational simplicity may be acceptable for small plans with small liabilities, it would unacceptable for large plans that are sponsored by large, financially sophisticated firms.

Question: Some have suggested that a yield curve would force more mature industrial companies to cut back or drop their pension plans. Some have even suggested that companies will spin off subsidiaries with older workforces to limit pension funding exposure. How do you respond to these concerns?

Answer: We do not believe that this would be a problem. Current law restricts the extent to which a company can establish a separate subsidiary to hold its pension liabilities.

First, section 4069 of ERISA authorizes the PBGC—the Federal agency that guarantees pension liabilities in the event of plan termination—to go after the entities that were in the company's controlled group of corporations at the time of the transaction for up to 5 years after that transaction if "a principal purpose" of the transaction was to "evade liability" under the plan termination provisions of ERISA. This is an important safeguard for plan participants in the spun-off subsidiary.

Second, a formation of a separate subsidy would require splitting the pension plan into a separate plan with similar benefits for the subsidiary. Plan sponsors can do this split currently. However, for a plan split, each such plan would have an appropriate portion of the assets and liabilities, and each plan would be subject to the minimum funding rules, including the accelerated deficit reduction funding requirements. The result, under the Administration's yield curve approach of valuing liabilities, would be that the plan with younger employees would use rates of interest that are generally higher on the yield curve to discount most of their future benefit payments—resulting in potentially slower funding—but the other plan would have to use rates of interest that are lower on the yield curve—resulting in faster funding, indeed the funding for the plan with the older workers would have disproportionately faster funding so that the combined result would often result in funding on a combined basis that is faster than if the plan had not been split. Therefore, the total contributions between the two plans would be the same or higher than prior to the spinoff.

Third, the formation of a separate subsidiary will often be unavailable because of employment agreement restrictions, such as requiring the consent of the union where the spun off plan covers union members. In Varity vs. Howe, the Supreme Court made it clear that the employer could not disguise the risks of a separate subsidy pension plan from employees. So companies where consent is required will have to honestly tell employees and the employee's representatives the reason behind the spinoff.

Question: We heard from the second panel that a yield curve would require the use of bonds of durations with very thin markets. Mr. Porter pointed out that single events can have a large impact on the rates if the bond index is not broad enough. How would Treasury address this potential problem?

Answer: As I mentioned in my testimony, the Treasury would undertake this process using a formal notice and comment rulemaking process to ensure market transparency and to incorporate input from all interested parties in final development of the yield curve. Although the groundwork is well established, we certainly plan to work with all stakeholders to finalize the methodological details of the ultimate yield curve. There will be ample opportunity for all stakeholders to bring potential problems to our attention.

I do not believe the issue you raise is a problem. As I mentioned in my testimony and in response to question 6, yield curves used to discount pension benefit payments have been available for a number of years and are mandated for and used in financial accounting. The methodology that Treasury is likely to adopt is widely accepted and extrapolates the shape of the corporate yield curve using the shape of the Treasury yield curve because of the thinness of the market for corporate bonds of some durations, especially long-term bonds. Thus thin markets for bonds of some durations is not an issue.

Question: Dr. Weller testified that eliminating smoothing would be counter-cyclical. That's because interest rates tend to drop during a recession. Eliminating smoothing (i.e., not allowing the use of higher interest rates from earlier years) will increase the amount of cash companies have to put in their plans during economic bad times (and reduce the amount that goes in during good times). Please comment on this criticism.

Answer: Smoothing reduces the accuracy of liability measures and the smoothing in current rules has failed to achieve stability in annual contributions. Smoothing delays recognition that a plan's funding situation has changed. In recent years smoothing the discount rate delayed recognition that plan liabilities had risen as a consequence of falling interest rates. Because the smoothing delayed this recognition plans did not respond in a more timely manner. Furthermore, the effects of those lower rates will remain a critical factor in plan funding requirements several years after rates begin to rise again.

Pension liability computations should reflect the current market value of future benefit payments—this is a key component of accuracy. Plan sponsors and investors are interested in the current value of liabilities in order to determine the demands pension liabilities will place on the company's future earnings. Workers and retirees are interested in the current value of liabilities so that they can determine whether their plans are adequately funded.

In summary, smoothing mechanisms will contribute to, not eliminate funding volatility.

[Additional written questions submitted by Mr. Tiberi to Ms. Combs and her responses follow:]

Questions from Representative Patrick J. Tiberi to the Honorable Ann L. Combs

Question: Given the fact that there are over 9 million workers who participate in multi-employer plans not addressed by the Administration's proposal, does the Administration intend to address these same issues in multi-employer plans at some date in the near future?

Answer: In connection with single employer plans, the Administration has proposed requiring more accurate measurement of liabilities, more transparency of funded status, and full funding of new benefit promises made by at-risk plans. The Administration has also signaled its intent to pursue fuller reforms to single employer plan funding rules.

We agree that participants in multiemployer plans, like those in single employer plans, deserve assurance that their plans are soundly funded. We therefore are open to considering similar reforms to multiemployer plan requirements. In considering such reforms, however, it is advisable to take into account important differences between single- and multiemployer plans.

While there are significant risks facing the multiemployer program, these risks may be less than those facing the single-employer program. For example, several employers rather than just one support each multiemployer plan, and employers leaving multiemployer plans are generally liable for their share of any underfunding. Multiemployer plans are covered under a separate PBGC insurance program that includes loans to insolvent plans, lower premiums and a lower guaranty limit than that of the single-employer plan program.

Question: The Administration's proposal includes prohibiting a company from raising benefit levels if a company falls below a certain termination liability funding threshold. Given the need to protect pensions of workers in all defined benefit plans, does the Administration support a minimum funding amount for benefit increases for multi-employer pension plans?

Answer: The Administration is willing to consider reforms of this sort. It is especially important that at-risk plans not make additional benefit promises without adequately funding them. The Administration has proposed new restrictions for single employer plans where the plan sponsor is bankrupt or has a credit rating below investment grade and the plan is seriously underfunded. The Administration looks forward to working with Congress to determine the circumstances when multiemployer plans are at similar risk and what restrictions might be appropriate when such risk exists.

Question: Single employer plans have a minimum 90% asset to benefit ratio requirement while multi-employer plans have no such requirement. Should there also be a required minimum 90% asset to benefit ratio requirement for multi-employer plans? If not, please explain your rationale and an alternative method for ensuring that a multi-employer plan participant is protected against inadequate funding.

Answer: Multiemployer plans are not subject to the deficit reduction contribution requirements (DRC) that apply to significantly underfunded single-employer plans. In general, a plan is subject to the DRC requirement in a plan year when the value of its assets is less than 90 percent of its current liability.

However, Congress in 1980 enacted the Multiemployer Pension Plan Amendments Act (MPPAA) that subject multiemployer plans to mandatory requirements for financially weak plans in "reorganization" that do not exist for single employer plans. A multiemployer plan is considered in "reorganization" where the plan's retiree amortization benefits over a 10-year period exceed the plan's net charge to its standard funding account.

Question: The focus over the last few years has been on single employer plans, and SEPs of companies that are publicly-held and therefore have a rigorous SEC quarterly disclosure schedule. In contrast, multi-employer plans have no such SEC disclosure requirement and are run by a private board of trustees. As the Administration pursues the necessary goal of greater disclosure for SEPs, does it support greater disclosure for MEPs as well? If so, please elaborate on the various disclosure options which may appear viable to your experts.

Answer: Public companies with single employer plans currently file with the SEC both 10–Ks (annual reports) and 10–Qs (quarterly reports). The 10–K report sets forth current pension data required by the Financial Accounting Standards Board (FASB), but the 10–Q report does not update that data each quarter.

Given that the need for retirement security is the same, the Administration favors transparency for both single-employer and multiemployer plans. The Administration will carefully consider whether the same kinds of disclosure requirements it has proposed for single employer plans should also apply to multiemployer plans, taking into accounts the differences between the two.

Chairman JOHNSON. The hearing will come back to order. The second panel has their seats, and they are all ready. I would ask at this time for my Co-Chairman, Chairman McCrery, to introduce the second panel. Go ahead, Chairman McCrery.

Chairman MCCRERY. Thank you, Chairman Johnson. We have a distinguished panel to deliver remarks and answer questions for us this afternoon. First, is Mr. Kenneth Porter. Mr. Porter is Director of Corporate Insurance and Global Benefits Financial Planning for the Dupont Company. He is responsible for global property and casualty insurance risk and for the worldwide financial planning and actuarial policy for employee and retiree benefits. He is currently the director of both the ERISA Industry Committee and the American Benefits Council, and is a member of the Wharton Executive Education Advisory Board.

Mr. Porter previously served as Chair of the ERISA Industry Committee and the American Benefits Council. He is also a member of Financial Executives International, an enrolled actuary, a member of the American Academy of Actuaries and a Fellow of the Conference of Consulting Actuaries. He has previously testified before Committees and Subcommittees of the U.S. Congress, the U.S. Department of Labor, the Treasury Department, and the PBGC.

Next we have Mr. Kenneth Steiner. Mr. Steiner is a consulting actuary with over 30 years of pension plan consulting experience. He has worked with single employer plans, multi-employer plans and plans sponsored by governmental agencies. His areas of expertise include plan design, plan funding, accounting under Financial Accounting Standards Board Statement No. 87, and communication with plan participants. Mr. Steiner was appointed resource actuary for Watson Wyatt Worldwide in October 2000 and now works in the firm's Washington, D.C., office where he provides technical and practical guidance to Watson Wyatt actuaries in the United States. Mr. Steiner is a Fellow of the Society of Actuaries, a Fellow of the Conference of Consulting Actuaries, a member of the American Academy of Actuaries and an Enrolled Actuary under ERISA. He holds a BA degree from the University of California at Davis.

Next, a fellow Louisianian, Mr. Ashton Phelps, Jr. Mr. Phelps has been President and Publisher of the Times-Picayune of New Orleans, Louisiana, since December 1979. He has also served as Chairman of the Auditing Committee of the Associated Press, as a member of the boards of the Southern Newspaper Publishers Association and the Southern Newspaper Publishers Association Foundation, and as President of the Louisiana Press Association. Mr. Phelps received his BA degree from Yale University, and I, as a Louisiana State University Law School graduate, can say the only black mark on his record is, he has a JD from Tulane University Law School.

Last on this afternoon's panel is Dr. Christian Weller. Dr. Weller is an economist for the Economic Policy Institute in Washington where he has worked as an international macroeconomist since 1999. Prior to joining the Economic Policy Institute, he worked at the Institute for European Integration Studies at the University of Bonn in Germany, the Department of Public Policy of the American Federation of Labor and Congress of Industrial Organization (AFL–CIO), and spent time working for banks in Germany, Belgium and Poland. Dr. Weller holds doctoral and master's degrees from the University of Massachusetts and a degree in Economics from the

University of Konstanz in Germany. Mr. Chairman, that concludes the introduction of our witnesses this afternoon.

Chairman JOHNSON. Thank you, Chairman McCrery; I appreciate those introductions. We appreciate you being here. Are you all aware of our light system from the previous panel? Mr. Porter, you may begin your testimony.

STATEMENT OF KENNETH W. PORTER, DIRECTOR, GLOBAL BENEFITS, DUPONT COMPANY, WILMINGTON, DELAWARE, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL, THE BUSINESS ROUNDTABLE, THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, THE ERISA INDUSTRY COMMITTEE, THE FINANCIAL EXECUTIVES INTERNATIONAL, THE NATIONAL ASSOCIATION OF MANUFACTURERS, AND THE U.S. CHAMBER OF COMMERCE

Mr. PORTER. Chairman Johnson, Co-Chairman McCrery, Members of the Committee, it is an absolute pleasure to be here today and to testify in these important matters.

I am appearing on behalf of the American Benefits Council, the Business Roundtable, the Committee on Investment of Employee Benefit Assets, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the U.S. Chamber of Commerce. It is an honor, distinctly, to be able to share with you the concerns of industry.

We have broad agreement that there is an immediate need to fix something that is broken. The question is not whether to fix it, it is how and when. We have two obvious alternatives before us today. One is the rates inherent in the proposals from Representatives Portman and Cardin and the other presented by the Treasury Department just last week.

I would like to start off by sharing just a little perspective because I think it is helpful. In the heat of the debate that we have had in recent weeks over these issues, I think we have lost sight in some discussions of a historical perspective.

When ERISA was enacted and debated back in the 1970s, there was a cogent, well-defined, long-term retirement income policy articulated for this Nation. In the context of that, funding rules and other participation rules were established that had the effect of encouraging employers to sponsor and maintain long-term retirement income plans. Over the years, there have been a number of bulletin changes to ERISA. The net effect is that we now have in ERISA about a dozen different definitions of plan liability.

We have heard testimony that talks in terms of being the liability, the correct measure, but yet Congress in its—its historical manifestations of ERISA have now given us 12 definitions of liability. When a plan participant asks us what the liability of the plan is, we are really hard-pressed to give them a single answer, and we need to know what the purpose of their question is so we can give them an answer that befits the question.

The Financial Accounting Standards Board, in adapting standards for employer accounting, didn't like any of those dozen definitions and gave us two more; the International Accounting Standards Board wants to give us yet another. So, we don't have a single or unified view of what the correct measure of employed pension liabilities are.

There are lots of views. There is lots of dissension on what that is. It is not universal. What we are now being presented with is, what do we do with one of those measures that is currently defective?

If you look at all of the dozen measures of liability in ERISA, those related to the 30-year Treasury bonds only reflect a couple of those liabilities. The liabilities associated with normal pension funding do not use the 30-year Treasury bonds. Liabilities associated with most disclosure do not use the 30-year Treasury bond. Some of the PBGC measurements do not use the 30-year Treasury bonds. In fact, what you find if you look at all the liabilities in ERISA, the 30-year Treasury bond reflects two specific areas of liability; one is the variable rate premium and the other is the so-called DRC.

Now, there has been some discussion, as if this liability was the liability for the pension plan and yet ERISA, that there is normal funding. There are full funding limits, and in some cases where there needs to be, there should be a DRC measured according to, currently, the 30-year Treasury bond yield interest rate.

Three years or so ago, when the Treasury Department decided, for sound fiscal reasons, that it was appropriate to start buying back 30-year Treasury bonds; and then, more recently, to stop selling them in the first place, discount rates on long-term Treasuries started to decline rapidly. In fact, earlier this year, in late April, early May, when the Federal Reserve Chairman suggested—confirmed a rumor that there may be an additional buy-back of 30-year Treasury bonds to help stimulate the economy, 30-year Treasury bonds dropped 70 basis points in 3 weeks.

Every time the Federal Reserve adjusts interest rates to stimulate the economy, the minimum contribution applied by the deficit reduction goes up, and the very companies that we are hoping will help stimulate the economy with low interest rates are forced to divert more money into their pension contributions through lower interest rates. In fact, pension funding has become a counterweight to the growth of the economy during a difficult time. The reverse has been true, in a sense, in strong times, where pension funding is not permitted to be made during a strength and required to be made during weakness. This is a flawed attempt at a noble cause.

We believe very strongly that no government bond, therefore, can be used for pension funding purposes because it holds pension funding subject to the legitimate needs of the U.S. monetary and fiscal policy. We need something that is independent of the fiscal policy to drive our pension funding. That is why we strongly support the interest rates inherent in the proposals of Representatives Portman and Cardin. These provide a very strong basis for funding. Interestingly enough, if you go back to 1987 when Congress—I am sorry.

Chairman JOHNSON. Can you begin to close?

Mr. PORTER. I will close.

Chairman JOHNSON. Thank you.

Mr. PORTER. As we go back to 1987 when Congress proposed this particular portion of the bill, what is in the Portman-Cardin bill today is very consistent with the original intent of this portion of law.

Before us, we believe, is the choice between something that is short-term and long-term. We believe that what is represented by the Portman-Cardin bill in interest rates is more like a technical correction for what we already have in law, whereas what the Treasury Department has proposed is a fundamental, sweeping change. We need to understand national policy before we make sweeping change.

[The prepared statement of Mr. Porter follows:]

Statement of Kenneth W. Porter, Director, Global Benefits, DuPont Company, Wilmington, Delaware, on behalf of the American Benefits Council, the Business Roundtable, the Committee on Investment of Employee Benefit Assets, the ERISA Industry Committee, the Financial Executives International, the National Association of Manufacturers, and the U.S. Chamber of Commerce

Chairmen of the Subcommittees and Members, thank you for the opportunity to present the joint views of the American Benefits Council, the Business Roundtable, the Committee on Investment of Employee Benefit Assets, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the U.S. Chamber of Commerce—organizations that represent a broad cross-section of American business and pension plans. My name is Kenneth W. Porter, Director, Global Benefits, Dupont Co. I am serving as a spokesman today, however, for these organizations, each of which has a vital interest in encouraging the creation of a regulatory climate that fosters the voluntary creation and maintenance of defined benefit pension plans for employees, and which come before you today with a common voice.

In our view, the need to replace the obsolete 30-year Treasury bond interest rate used for pension calculations is the most pressing issue facing employers that sponsor and individuals who rely on defined benefit pension plans today. Immediate action is required to correct the problem.

We commend the Bush Administration for stepping forward with a set of principles that recognize the need for permanent replacement of the obsolete 30-year Treasury bond rate. In particular, we are pleased that the Administration included in their recommendations the replacement of the 30-year Treasury bond rate with a conservative, high-quality corporate bond rate. The use of a composite corporate bond interest rate to replace the 30-year Treasury rate has been widely discussed for almost a year, enjoys strong, bipartisan backing, and has support across the ideological spectrum. Use of a composite, high-quality corporate bond rate will appropriately measure pension liability, will improve predictability of plan obligations, and is consistent with the pension rules previously adopted by Congress.

We do not, however, believe that the addition of a "yield curve" concept referred to in the Administration's recommendations has been sufficiently developed or examined, nor do we believe that it will provide the certainty and clarity in defined benefit plan funding obligations that is urgently needed to ensure the continued viability of our defined benefit pension system. Consideration of the fundamentally new and untested yield curve regime should only occur in the context of a very careful review of all the pension rules and with a better understanding of the macroeconomic consequences of such a change.

Under current law, employers that sponsor defined benefit pension plans are required to use the 30-year Treasury bond rate for a variety of pension calculation purposes, including plan funding requirements, calculation of lump sum distributions, and liability for variable premium payments to the Pension Benefit Guaranty Corporation (the "PBGC"). The various provisions of federal law requiring use of the 30-year Treasury bond rate for pension calculations were enacted in 1987 and 1994 when there was a robust market in 30-year Treasury bonds and the yields on those bonds were an acceptable proxy for corporate bonds and other long-term debt instruments. While a variety of rates were discussed, it was believed at the time the 30-year Treasury rate was first selected in 1987 that use of the rate would result in companies setting aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

Beginning in 1998, the U.S. Treasury Department began a program of retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year Treasury bonds altogether. With commencement of the buyback program, yields on 30-year Treasury bonds began to drop and to diverge from the rest of the long-term bond market—a divergence that increased precipitously after the October 2001 discontinuation. As a result of the shrinking supply of these bonds (particularly when coupled with continuing demand for the relative safety of U.S. government debt), the secondary market interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other long-term bonds. The Treasury Department itself has concluded, "[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities." [1]

The result of these low rates is to artificially but substantially inflate pension liabilities and consequently increase required pension contributions and PBGC premiums. The inflated pension contributions mandated by use of the obsolete 30-year rate exceed what is necessary to fund promised benefits and produce a series of disastrous results for employees, employers, and our economy as a whole.

More and more of the companies that confront these inflated and unpredictable contributions (which can often be several times greater than prior year contributions, due to the non-proportional nature of the pension funding rules) have concluded that they have no 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 have no pension program whatsoever. Government data reveals that defined benefit plan terminations have continued to accelerate in recent years, with a 19% drop in the number of plans insured by the PBGC from 1999 to 2002 (from 39,882 to 32,321, down from a high of 114,396 in 1985). 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 on the upswing in recent months. A major consulting firm reports that 21% of surveyed defined benefit plans intend to scale back benefits for current employees through a freeze or other mechanism and 27% intend to offer less generous benefits for new hires.

Today's inflated funding requirements also harm the economy as cash unnecessarily poured into pension plans diverts precious resources from investments that create jobs and contribute to economic growth. Facing pension contributions many times greater than they had anticipated, employers are having to defer steps such as hiring new workers, investing in job training, building new plants, and pursuing new research and development. Yet these are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, and return the country to robust economic growth. Some employers may be forced to lay off employees in order to accumulate the required cash contributions. Moreover, financial analysts and financial markets are now penalizing companies with defined benefit pension plans because of the unpredictable future pension liabilities that result from uncertainty as to what will replace the 30-year Treasury bond rate. The resulting pressure on credit ratings and drag on stock prices, which harms not only the company but also its shareholders, is a further impediment to strong economic growth.

Because of these problems and the fact that the use of an obsolete interest rate for pension calculations makes no sense from a policy perspective, Congress acted in the March 2002 economic stimulus bill to provide temporary relief that expires in 2003. Since 2002, the 30-year Treasury bond rate has only become progressively more obsolete, and the associated problems described above have become more grave. In short, the 30-year Treasury bond rate is a broken rate that must be replaced. To continue to base pension calculations on an obsolete interest rate undermines the very foundation of our pension laws and defined benefit plan system.

We strongly endorse replacing the broken 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. H.R. 1776, a comprehensive pension reform bill authored by Representatives Rob Portman (R–OH) and Ben Cardin (D–MD), includes a provision (section 705) that does exactly that.

A corporate bond composite rate steers a conservative course that fairly and appropriately measures pension liability. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. Such rates would also provide the kind of predictability that is necessary for company planning of pension costs. Moreover, use of a corporate bond blend would achieve trans-

[1] Testimony of Peter Fisher, Undersecretary for Domestic Finance, U.S. Department of Treasury, before the House Ways and Means Subcommittee on Select Revenue Measures (April 30, 2003).

parency given today's daily publication of corporate bond rates and instant access to market information through electronic means.

Use of such a conservative corporate bond blend would ensure that plans are funded responsibly. Moreover, the strict funding requirements that Congress adopted in 1987 and 1994 would continue to apply. Substitution of a corporate bond blend would merely mean that companies are not forced to make the extra, artificially inflated contributions required by the obsolete 30-year Treasury rate. This is why stakeholders from across the ideological spectrum—from business to organized labor—agree that the 30-year Treasury rate should be replaced by a conservative, high-quality corporate bond blend.

The Treasury Department has also suggested that after two years of utilization of a corporate bond rate, a so-called "yield curve" concept should be adopted. While a fully developed yield curve proposal has not been issued and the specifics underlying the concept are unknown, it appears that it would involve a complicated regime under which the interest rates used for measuring pension liability would vary with the schedule and duration of payments due to each plan's participants.

Although neither we nor the Congress yet have sufficient detail to fully analyze the Treasury Department's yield curve approach, it is clear that a yield curve regime would represent a very significant change in our pension system. It would lack the transparency and predictability of a conservative corporate bond blend, and also not be as well understood. At a minimum, it raises a large number of policy concerns and unanswered questions that have not been adequately studied or addressed. Based on our current understanding of the concept, we are concerned that the yield curve would:

- ***Exacerbate funding volatility*** by making liabilities dependent not only on fluctuations in interest rates, but also on changes in the shape of the yield curve (caused when rates on bonds of different durations move independent of one another) and on changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, etc.). The "smoothing" techniques that allow employers to use the average of the relevant interest rate over several years in valuing liabilities to reduce funding volatility also would not be allowed.
- ***Increase pension plan complexity*** (already a significant impediment to defined benefit plan sponsorship) by moving from a system based on a single interest rate to a much more complex system that relies on a multiplicity of instruments with widely differing durations and rates.[2]
- ***Make it difficult for employers to plan and predict their pension funding obligations*** (another significant impediment to defined benefit plan sponsorship today).
- ***Result in less ability for a plan sponsor to fund pension plans*** while participants are younger because it would delay the ability to deduct contributions to periods when the workforce is more mature and declining. In addition, important flexibility would be lost by removing the corridor surrounding the interest rate (historically 90% to 105% of the averaged rate). The loss of such flexibility would make it harder for employers to fund their plans in times when corporate resources are more plentiful.
- ***Require use of bonds of durations with very thin markets*** (because few such bonds are being issued). As a result, single events (e.g., the bankruptcy of a single company unrelated to the plan sponsor) could affect the rate of a given bond index dramatically, thereby leading to distortions in pension calculations and even potential manipulation.
- ***Have uncertain macroeconomic effects*** on the economy as a whole and on particular companies, industries, and classes of workers.
- ***Involve a considerable delegation of policy authority*** by Congress to the Executive Branch since the entirety of the construction and application of the yield curve would apparently be left to the regulatory process.
- ***Not necessarily result in a more accurate measure of liabilities,*** since the theoretically more "precise" plan-by-plan yield curve interest rate would not be accompanied by other similar plan-specific assumptions.

There also are many additional unanswered questions created by the Administration's yield curve concept. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest and conversion to annuities of employee contributions to defined benefit plans, and the payment of interest credits under hybrid

[2] Although statements have been made that the yield curve adjustment would be simple and easy, the fact that the Treasury Department has failed to provide full details on the proposal, even after months of study, belies the simplicity of the proposal.

pension plans. Many of these uncertainties raise serious policy issues. For example, if application of a yield curve resulted in higher lump sum payments for older workers compared to younger ones, that result must be examined closely to determine whether it would modify ERISA's vesting standards by increasing backloading of benefits. It is also unclear how, or even if, the yield curve concept would apply for purposes of calculating PBGC variable premium obligations, another very major and unaddressed policy question.

It is unrealistic to believe that all of these outstanding issues and concerns raised by the yield curve concept could be addressed in the short time in which Congress must act on a replacement for the 30-year Treasury rate. Such an untested change—from our current rules that allow for an interest "corridor" and an averaged interest rate to a yield curve concept applied on a "spot" basis—would require a complete reevaluation of our pension funding rules (as today's rules are premised on these corridor and averaging features). In addition, it is unclear from the limited information available how the very significant issues of transitioning from a system based on corridors and averaging to a less flexible system would be resolved. At a minimum, to the extent that this type of major overhaul of our pension funding rules is considered, it should be done in the context of a more fundamental review through deliberative Congressional study and the regular legislative process.

We also want to briefly touch on other issues referenced in the Administration's pension reform principles—namely additional disclosure of pension information and a new idea that would mandate freezes in certain private-sector pension plans. First, it is important that any required disclosure be responsible and serve a clearly defined need. Disclosure that provides a misleading picture of pension plan finances or that is unnecessary or duplicative of other disclosures could be counter-productive. For example, the Administration's proposal to key disclosure off of a plan's termination liability could provide a misleading depiction of plan finances for ongoing plans that are reasonably well funded because these plans are not in any danger of terminating. This type of misleading disclosure could unnecessarily and falsely alarm plan participants, financial markets, and shareholders. Moreover, termination calculations of the type being proposed are among the most costly and administratively burdensome calculations a plan can be asked to perform. Similarly, the Administration's proposal to allow publication of certain information that today is provided on a strictly confidential basis to the PBGC whenever a plan is underfunded by more than $50 million would provide yet another impediment to companies' willingness to sponsor defined benefit plans, and ignores the size of the plan and its assets and liabilities. For many pension plans with billions of dollars in assets and obligations, such a relatively modest amount of underfunding is often quite normal and appropriate. It should not be cause to trigger publication of information on an ad hoc basis that could again sound unnecessary alarm bells.

We also believe that the Administration's proposal that would freeze private sector pension plans and remove lump sum rights when a company reaches a certain level of underfunding and receives a junk bond credit rating requires careful review. While we appreciate (and share) the Administration's concerns about PBGC guarantees of benefit promises that are made by financially troubled companies, their proposal raises technical and policy issues that require further examination. For example, there is no definition of "junk bond" status provided, and there is a question of whether it is appropriate to mandate a cutback in participants' benefits based on a third-party's determination of credit rating. Moreover, it is not clear why employees should lose their rights to certain forms of benefit when their company experiences financial trouble.

We thank you for the opportunity to present our views. All parties agree that the immediate problem is clear—the need to replace the obsolete 30-year Treasury bond rate. The solution is to permanently substitute an interest rate based on a composite of high-quality corporate bond indices.

Once that problem is solved, we also look forward to working with your Committees and the Administration on a comprehensive discussion of the long-term funding challenges facing our pension system as well as proposals designed to provide additional protection to the PBGC. Let us emphasize that employers that responsibly fund their plans and pay PBGC's per-participant premiums share the same objective as the PBGC—ensuring a sound defined benefit system over the long-term. However, a failure to immediately deal with the 30-year Treasury rate anomaly through substitution of corporate bond blend threatens not only the future viability of our defined benefit retirement system but the economic recovery as well.

Chairman JOHNSON. Thank you, sir. Mr. Steiner, you may begin.

STATEMENT OF KEN STEINER, RESOURCE ACTUARY, WATSON WYATT WORLDWIDE

Mr. STEINER. Thank you, Chairman Johnson, Chairman McCrery, and distinguished Committee Members; thank you for inviting me to testify today. My name is Ken Steiner, and I am the Resource Actuary for Watson Wyatt Worldwide. Watson Wyatt is a human resources and benefits consulting firm employing nearly 6,300 associates worldwide. We are a major provider of actuarial consulting services to retirement plans in the United States.

At Watson Wyatt we believe that defined benefit funding rules should be carefully drafted to balance the security needs of plan participants and the PBGC with the business needs of plan sponsors. Plan participants need to be able to count on receiving the benefits they have earned, the PBGC needs to control its risk, and plan sponsors need plans that are consistent with their business objectives, including having funding requirements that are flexible, predictable and stable. It is not a simple task to balance all these needs.

One thing is clear: since defined benefit plan sponsorship is generally a voluntary action taken by an employer, it is quite likely that many plans would be terminated or frozen if these plans ceased to meet defined benefit plan sponsors' business needs.

It is no secret, and this Committee has mentioned several times that defined benefit plan sponsorship has declined over many years; and this trend continues today. Given the rapid decline in the number of defined benefit plans, we are concerned that if not carefully crafted, actions by Congress to significantly change the funding and disclosure rules at this time will result in even more defined benefit plan terminations or plan freezes. If this occurs, America's workers will be the ultimate losers.

The Administration has indicated that its proposal constitutes only the first phase of several phases of funding reforms to be proposed. We support the undertaking of a comprehensive study of funding requirements of our pension system. We also support certain aspects of the Administration's proposal, including the use of the corporate bond rate as a replacement for the now defunct 30-year Treasury rate and the use of a more reasonable basis to determine lump sum distributions. However, we believe other aspects of the proposal should be delayed so that they can be better coordinated with changes anticipated in future reform proposals.

As mentioned by Chairman Johnson in the earlier panel's discussion, over the last few years the investment climate has been marked by the equivalent of a "perfect storm," leaving many defined benefit plan sponsors with underfunded plans. However, a significant portion of the perceived underfunding results from the use of the obsolete 30-year Treasury bond to value liabilities. This low and discontinued rate makes plan liabilities appear larger than they really are, and consequently overstates plan contribution requirements.

To give you a sense of the magnitude of the problem, we have examined the pension contribution of Fortune 1000 companies that sponsor defined benefit plans, and for the last 3 years, from 1999 to 2001, total contributions to the defined benefit plans from these companies were $41 billion. By comparison, in 2002 alone, these companies contributed a total of about $43 billion, more than had been contributed for the prior 3 years combined and about triple the total contributions made just the year before.

No one knows what plan sponsors will actually contribute to their plans for 2003 and the next few years. However, contributions can be estimated based on prior experience and assumptions about the future. Based on certain assumptions, we estimate the total contributions by Fortune 1000 companies in 2003 will be about $83 billion, almost double the total in 2002 and six times the amount contributed in 2001.

Under current law and continued use of the obsolete 30-year Treasury rate, we estimate contributions in the aggregate for the next 2 years, 2004 and 2005, will total about $160 billion, even assuming plan assets earn 8 percent per annum after 2002. These large contributions divert corporate assets needed to grow companies and provide jobs.

Given these daunting numbers, Watson Wyatt is pleased that the use of a corporate bond yield rate has been proposed as a replacement for 30-year Treasuries in determining corporate liability interest rate, both as part of the Portman-Cardin bill, H.R. 1776, and for the first 2 years of the Administration's proposal. However, we have concerns about the Administration's proposal to move to a corporate bond yield curve over the next 5 years.

Based on our understanding of the yield curve proposal, the changes will likely increase plan Administration fees, increase volatility from year to year, reduce employer contribution flexibility and make it more difficult for sponsors to budget contribution requirements from year to year. None of these results is likely to encourage plan sponsors to maintain their plans.

By eliminating the 4-year averaging feature under current law, contribution requirements will become much more volatile despite the testimony to the contrary in the earlier panel. As an example, we have only to look at experience over the last 12 months. For the period ending May 31st, corporate bond rates have declined about 170 basis points. For a typical plan, this would have an impact of increasing plan liability by about 22 percent. By comparison, under existing law, the decrease in the 4-year average interest rate over the past 12 months is expected to increase plan liability by only about 3 percent. Therefore, we believe it is important to maintain the averaging features of current law. Thank you.

[The prepared statement of Mr. Steiner follows:]

Statement of Ken Steiner, Resource Actuary, Watson Wyatt Worldwide

Chairman Johnson, Chairman McCrery and distinguished committee members, thank you for inviting me to testify on "Examining Pension Security and Defined Benefit Plans: The Bush Administration's Proposal to Replace the 30-Year Treasury Rate." My name is Ken Steiner, and I am the Resource Actuary for Watson Wyatt Worldwide. Watson Wyatt is a human resources and benefits consulting firm employing nearly 6,300 associates worldwide. We are a major provider of actuarial and consulting services to retirement plans in the United States.

General Comments

At Watson Wyatt we believe that defined benefit plan funding rules should be carefully drafted to balance the security needs of plan participants and the Pension Benefit Guaranty Corporation (PBGC) with the business needs of plan sponsors. Plan participants need to be able to count on receiving the benefits that they have earned. To be financially viable, the PBGC needs to control its risk and at the same time encourage companies to maintain their defined benefit plans. In addition to having plans that help them accomplish their business objectives, plan sponsors need to have contribution flexibility, predictability and stability. Ideally they would like to be able to fund more during good economic times and less during poor economic times. It is not a simple task to balance all these needs.

One thing is clear; since defined benefit plan sponsorship is a voluntary action taken by an employer, it is quite likely that plans will be terminated if these plans cease to meet the sponsor's business needs. It is no secret that defined benefit plan sponsorship has declined over many years—from 114,000 federally insured plans in 1985 to under 33,000 in 2002. And this trend continues today. Over the past three years, the PBGC has reported a decrease of over seven thousand five hundred plans, almost a 20% drop in defined benefit plan sponsorship during that period. In addition, a significant number of plan sponsors have recently frozen plan benefits. Given the rapid decline in the number of defined benefit plans, we are concerned that, if not carefully crafted, actions taken by Congress to significantly change the funding and disclosure rules at this time will result in even more defined benefit plan terminations. Obviously if this occurs, America's workers will be the big losers.

Watson Wyatt recently reported that the number of employers with fully funded pension plans declined from 84% in 1998 to 37% in 2002. The decline would have been greater if Congress had not enacted a temporary interest rate correction provision. The drop in the number of fully funded plans has been reported in the media almost exclusively as a story about the precariousness of the pension benefits for participants in underfunded plans, but the use of artificially low interest rates to determine required employer contributions threatens the long-term viability of every pension plan in a voluntary system such as ours, regardless of funded status. The best way to ensure the financial security of working Americans is by preserving the defined benefit system, not imposing additional requirements that will drive more employers from sponsoring pension plans.

Defined benefit plans provide unique advantages for employees and employers. Annuity distributions are more prevalent in defined benefit than defined contribution plans, providing participants with a predictable income stream for life, no matter how long they live, and reducing the risk of retirement assets leaking from the system for other purposes. Defined benefit plans provide more flexibility in managing an employer's workforce, such as through early retirement window benefits and early retirement subsidies.

The Administration has indicated that its proposal constitutes only the first phase of funding reforms designed to protect workers' retirement security. We support a comprehensive study of current pension law with the objective of better meeting the needs of the three parties discussed above and encouraging expanded sponsorship of defined benefit plans. We would be happy to assist in such a study. However, we believe significant aspects of the current proposal should wait until a study has taken place. We support certain aspects of the Administration's proposal, including the use of a corporate bond rate as a replacement for the now defunct 30-year Treasury rate (with modificaiton as discussed below) and use of a more reasonable, market-representative basis to determine minimum lump sums. However, we believe other aspects of the proposal should be delayed so that they can be coordinated with changes that may be needed.

My written statement will focus on three important issues for this hearing, namely:

- The need for funding flexibility resulting from "perfect storm" conditions
- Our reaction to funding aspects of the Administration's proposal
- Our reaction to non-funding aspects of the Administration's proposal

Need for Funding Flexibility

Over the last few years, the investment climate has been marked by the equivalent of a "perfect storm," leaving many defined benefit plan sponsors with underfunded plans.' The interest rate used to determine a plan's liability has a significant impact on the employer's funding obligations, as does asset performance. As interest rates decline, plan liability and the need to make pension contributions also increase. In addition to the general decline in interest rates over the last several years, the discontinuance of the 30-year Treasury bond has depressed the rate used by employers to determine their funding obligations even further. As a result, contributions to these plans have increased significantly and are expected to increase further.

Under current law, if plan assets fall below 90 percent of a measure of a plan's benefit liabilities to participants known as the plan's "current liability," defined benefit plan sponsors may be subject to accelerated contribution requirements. This liability is calculated using a weighted four-year average of 30-year Treasury rates. The lower the interest rate used in the calculation, the higher the current liability and the required contributions. Even though the U.S. Department of the Treasury has stopped issuing the 30-year Treasury bonds, the IRS still estimates a yield for this now-hypothetical bond. The rate for June 2003 is 4.37 percent. Most plan sponsors, who generally take a long-term view of plan funding, believe that the IRS should use an interest rate closer to sponsor's projected long-term investments returns, such as 8 percent, to determine plan liability for funding purposes.

Congress provided some temporary relief to defined benefit plan sponsors in the Job Creation and Worker Assistance Act of 2002 (JCWAA). The JCWAA increased the maximum current liability interest rate from 5.99 to 6.85 percent for 2002 calendar year plans, and from 5.82 to 6.65 percent for 2003 calendar plan years. However, the temporary provisions of JCWAA are scheduled to expire at the end of the 2003 plan year. Upon expiration of JCWAA, we estimate that the maximum current liability interest rate will drop from 6.65% for the 2003 calendar year to 5.39 percent for 2004 calendar year plans and to 5.05 for 2005 calendar year plans.

Contributions to defined benefit plans sponsored by Fortune 1000 companies totaled $11 billion in 1999. These companies contributed $16.1 billion in 2000 and $14 billion in 2001. So in the three-year period from 1999 to 2001, these plan sponsors contributed a total of $41 billion to their defined benefit plans. But the years of low contributions have ended. In 2002 alone, the Fortune 1000 defined benefit plan sponsors contributed $43.5 billion—more than the contributions for the previous three years combined and almost three times the contributions made just the year before.

In 2002, total contributions represented about 180 percent of the estimated unfunded current liability for the Fortune 1000 companies with underfunded plans, determined using the maximum current liability interest rate (6.85 percent). Assuming that sponsors reduce their contributions for 2003 from 180 to 100 percent of the estimated unfunded current liability using the maximum current liability rate for 2003, it is estimated that Fortune 1000 companies will contribute about $83 billion to their defined benefit plans—almost twice 2002 contributions and around six times 2001 contributions.

Assuming that plan assets earn 8 percent per annum for both 2003 and 2004 and sponsors contribute 100 percent of their total unfunded current liability (counting plans whose assets exceed current liability as zero and using the highest permissible interest rate to determine current liability), we estimate that contributions would approximately total $160 billion for the next two years under current law.

The use of a corporate bond yield rate has been proposed as a replacement for 30-year Treasuries in determining the current liability interest rate, most recently as part of the Portman/Cardin bill (HR 1776). The Administration's proposal would use the same rate for 2004 and 2005 plan years. Based on the methodology described above, if we assume that monthly 30-year Treasury rates in the four-year average would be replaced by monthly Salomon Brothers Pension Liability Index rates, and the future index value would remain unchanged from its April 2003 value, we estimate that contributions for the two-year period would be approximately $45 billion—about $115 billion less than under current law.

Not all plan sponsors base contribution decisions on the current liability interest rate. For example, some plan sponsors contribute sufficient amounts to avoid accounting charges or PBGC variable rate premiums. So the methodology used to estimate contributions almost certainly overstates the effect of using a blended corporate bond rate on contributions that will be made in practice. However, without correction of the anomalously and inappropriately low rate required under current law, contribution amounts will be significant and inappropriately burdensome.

When the 30-year Treasury rate was adopted as the benchmark for plan funding, the top end of the range of rates employers could select from was a fair approximation for long term, high quality corporate bond rates. The Treasury Department's buyback and subsequent discontinuation of the 30-year bond has driven rates on these bonds to a level significantly below other conservative long-term bond rates. The result has been an artificial inflation in pension liabilities, with employers confronting overstated required pension contributions. These inappropriately higher required contributions divert corporate assets needed to grow companies, payrolls, and the economy.

Temporarily or permanently correcting interest rates used for funding purposes to more appropriate levels could help plan sponsors keep their plans afloat in these stormy economic times, which would certainly benefit plan participants as well. Adopting interest rates based on long term, high quality corporate bond rates, as proposed in Portman Cardin (and the Administration proposal for the next two years) would go far in providing plan sponsors with the funding flexibility they sorely need. As discussed below, if a blended corporate bond rate is used to replace 30-year Treasuries, we recommend that the lower end of the current liability interest rate be reduced from 90% to 80% to allow sponsors to increased flexibility to make higher contributions to their plans.

Funding Changes in the Administration Proposal

Under current law, a plan's current liability is determined based on a four-year weighted average of 30-year Treasury rates. The sponsor may select an interest rate between "corridors" of 90% to 105% of the resulting four-year average rate. Under JCWAA, the upper corridor was increased from 105% to 120% for 2002 and 2003 plan years only. The current liability interest rate is used to discount future benefit payments attributable to benefits earned to the date of the actuarial valuation to determine the present value of those payments. The resulting present value, which is compared with valuation assets, is called the plan's current liability. For many plans, the upper and lower corridors define minimum and maximum deductible contribution requirements. Thus, current law provides plan sponsors with contribution flexibility by allowing plan sponsors that wish to contribute more to their plans the ability to use a lower current liability interest rate. Further, the four-year average nature of the calculation helps to smooth the effect of significant changes in interest rates from year to year. Given the trend of rates and assumptions for trust fund growth, it is generally a relatively easy process under current law for employers to budget contribution requirements for the next year.

The Administration proposal would substitute a corporate bond rate blend as set forth in the Portman/Cardin pension legislation (H.R. 1776) for the 30-Year Treasury rates and maintain the four-year average and 90%–105% corridor for 2004 and 2005 plan years. It is anticipated that the use of a blended corporate bond rate will increase the upper end of the corridor by 100-150 basis points. Unfortunately, it would also increase the lower end of the corridor in a similar manner. Because the purpose of the proposal is to strengthen America's pension security, we believe that the lower end of the range should be reduced to 80% of the four-year average of the blended corporate bond rate. Current law already provides this flexibility by allowing the IRS to extend the lower end of the range, but we believe it should be incorporated in the legislation.

After 2005, the Administration proposal would transition over a three-year period to the use of a corporate bond yield curve. Once fully phased-in, the four year weighted average feature of current law would be gone, with the yield curve rate being used on much more of a spot-rate basis. The corridors in existing law would also disappear.

Under the yield curve proposal, instead of using a single interest rate to discount future expected benefit payments, a different discount rate will be used to discount each future year's expected payments. A particular year's discount rate (which will change every month) will be based on corporate bond yields for bonds with maturities in that year. The Administration proposal claims that this calculation will improve the accuracy of the pension liability discount rate and current liability calculation.

While providing more perceived accuracy to the determination of a plan's current liability, the Administrative proposal will likely increase plan Administration fees, increase volatility from year to year, reduce employer contribution flexibility and make it more difficult for sponsors to budget contribution requirements from year to year. The calculation of current liability will be significantly complicated by the need to use 30–60 different discount rates than the single discount rate anticipated under current law.

By eliminating the four-year average feature and interest rate corridors, contribution requirements will become much more volatile. For example, over the last 12 months ending May 31, corporate bond rates measured by the Salomon Brothers Pension Liability Index have declined by 170 basis points. For a typical plan, this would have the impact of increasing current liability by about 22 percent. By comparison, the four year weighted average of 30-year Treasury rates decreased from 5.68% to 5.39% over the same period. This decrease would be expected to increase current liability for a typical plan only by about 3%. Instead of reflecting only a portion of that decline under existing law, the yield curve would require reflection of the full decrease. Since interest rates can move significantly up and down over a fairly brief period, this can cause undesirable contribution fluctuations for sponsors that generally prefer stability. Further, since the corridors would be eliminated, it is not clear how flexible contribution requirements would be under the Administration proposal. Changes in the shape of the yield curve, which occurs when rates of different duration bonds move independently of one another, can also alter a plan's liabilities and required contributions even when long term bond rates or plan demographics do not change. Lastly, by basing contribution requirements on a yield curve determined close to the beginning of the plan sponsor's plan year, it will be more difficult for sponsors to know and budget for that year's contribution.

The Administration also proposes that all companies calculate and disclose the value of pension plan liabilities on a plan termination basis. This calculation is yet another very complicated calculation for most plans, and is in addition to the value of plan current liabilities that are used for funding purposes and reported in the plan's annual return. Our comments on this particular aspect of the proposal are set forth below; however, it is important to note that current liability will generally not be equal to plan termination liability. It is not clear that disclosure of a plan's funded status on a plan termination basis will provide meaningful information to plan participants. If Congress determines that additional participant disclosure concerning plan funding is necessary, it should be limited to plans sponsored by employers in bankruptcy or with below investment grade credit ratings, limiting any additional disclosure to those participants likely to need it and reducing unnecessary complication and confusion for plans that are unlikely to terminate with insufficient assets.

Other Aspects of the Administration's Proposal

Reforming interest rates used to determine lump sum distributions is also needed, as the discontinued 30-year Treasury bond rate is also used to determine the minimum value of lump sum distributions from defined benefit plans. Just as the current artificially low long term government bond rate inflates pension funding contributions, the rate inflates the lump sum value of participants' annuity benefits, providing a significant incentive for participants to elect lump sums over annuity distribution options. While participants certainly enjoy the increased value of their lump sums, and reasonable expectations of those participants near retirement should be protected, it is bad retirement policy to induce selection of lump sum distributions over annuity options. We support the Administration's proposal to determine minimum lump sums by phasing-in to a more reasonable basis over a five-year period. A two-year "grandfather" period of current law provisions does not appear to us to be unreasonable.

The Administration's proposal includes several items to increase disclosure to plan participants. According to the proposal, "too often workers are unaware of the extent of their plans' underfunding until their plans terminate, frustrating workers' expectations of receiving promised benefits." Accordingly, the Administration proposal would require disclosure of plan assets and liabilities on a termination basis in annual reporting to participants. Sponsors would also be required to report the plans current liability determined on the yield curve basis and the PBGC would be authorized to disclose to the public certain financial data from companies with more than $50 million of unfunded vested liabilities.

Calculation of a plan's termination liability can be extremely complicated. It involves the use of PBGC assumptions and, except for the fact that the same data is used, can take as much time and effort as the annual actuarial valuation to determine plan contribution requirements. While knowing that plan assets at the time of the last valuation equaled 70% of plan termination liability, for example, can be of some value to plan participants, this fact can also be easily misinterpreted. Upon an actual plan termination, amounts actually received by plan participants depend on a number of factors. It is highly unlikely that a plan with assets equal to 70% of plan termination liabilities would pay $.70 on the dollar to all participants. First of all, if the sponsor can afford it, the sponsor is obligated to make up the shortfall. Further, even if the plan sponsor cannot make up the shortfall, different participants are treated differently, depending on the priority assigned their benefits under PBGC rules. In this situation, some participants may receive 100% of their accrued benefits and some non-vested participants may receive 0%. Some vested highly compensated individuals whose benefits fall into lower priority categories may receive less than 70% because their benefits are limited by maximum PBGC guarantees. Therefore, providing information regarding plan termination liabilities in the aggregate will frequently fall short of the intent expressed in the Administration's proposal to avoid "frustrating workers' expectations of receiving promised benefits."

While this information may be of some value to participants in plans where plan termination with insufficient assets is a real possibility, it is likely to be confusing and irrelevant to participants in plans sponsored by employers able to pay all promised benefits if their plans were terminated.

As noted in the Administration's proposal, 90 percent of companies whose pension plans have been trusteed by the PBGC had junk bond credit ratings for the entire ten year period before termination. If additional administrative burdens are imposed on defined benefit plans in the name of strengthening America's pension system, such changes should focus on the companies that represent the greatest risk to participants' retirement benefits and the bulk of the PBGC's potential risk, and not on the majority of the remaining companies for which no strengthening is required to protect the interests of participants. Rather than burden companies that are financially strong and fully able to make good on their pension promises with complex and costly additional disclosure requirements of dubious value, we recommend that any additional disclosure requirements apply only to those companies in bankruptcy or those with below investment grade credit ratings.

Conclusion

I want to thank you for holding this hearing to discuss what our firm believes to be some of the most important retirement policy questions our nation faces. Defined benefit plans offer many unique advantages for employees and the employer sponsors of these programs sincerely believe in their value. Without prompt and reasonable action by Congress and the Administration, we fear these plans will continue to rapidly disappear from the American pension landscape.

Thank you very much for the opportunity to appear today. I would be pleased to answer any questions you may have.

Chairman JOHNSON. Thank you, sir. Mr. Phelps, you may begin.

STATEMENT OF ASHTON PHELPS, JR., PUBLISHER, TIMES-PICAYUNE, NEW ORLEANS, LOUISIANA

Mr. PHELPS. Chairmen McCrery and Johnson and Members of the Subcommittee, I am Ashton Phelps, Jr., Publisher of the Times-Picayune newspaper in New Orleans, Louisiana. I appreciate the opportunity to participate in this hearing.

Our newspaper maintains a defined benefits pension plan to provide retirement security for our employees and their families. I am glad that the Subcommittee and others in Congress are considering legislation to encourage the use of these kinds of plans. In my testimony I will concentrate on one single issue, namely, the need for a permanent replacement for the 30-year Treasury bond rate. This issue is critically important and immediate action is urgently required.

As you are well aware, employers have generally been required by law to use the 30-year Treasury bond rate to calculate their liabilities under their plans and for certain other purposes. In 2002, Congress wisely recognized that the plunging rate of the 30-year Treasury bond, which is no longer being issued, had resulted in inflated estimates of pension liabilities and, in turn, in substantial increases in funding requirements above the levels required to secure benefits. As a result, Congress enacted stopgap legislation to allow employers to use a more realistic discount rate for 2002 and 2003.

As we meet here today, however, employers are facing the risk that the old rules will snap back in 2004, despite the almost universal agreement that you have heard here today that the 30-year Treasury bond rate is no longer the appropriate benchmark. To prevent such a result, Congress needs to act and needs to act now. If Congress fails to act promptly, employers will have no choice but to begin soon to manage their businesses and their cash flows on the assumption they will be faced with substantial increases in pension funding requirements next year.

In the uncertain economic climate we have now, employers may have to take steps that would otherwise be unnecessary and undesirable. These steps could include limiting employee benefit improvements, reducing capital spending for new plant and equipment, or curtailing spending for research and development.

Our main point here today is that these types of actions could begin to occur now, given the uncertainty as to whether Congress will act. If actions such as these do occur, there could be adverse effects that might not be fully reversible if Congress waits until near the end of this year to act.

I think there is broad consensus that it would be better for Congress not simply to extend the stopgap legislation for an additional period of years, but instead to enact a permanent replacement. The pending Portman-Cardin legislation does this by providing for the use of the corporate bond index to determine the discount rate employers would use to calculate their pension liabilities and their required contributions, as well as for other pension-related purposes.

The Portman-Cardin funding approach is supported by both the AFL–CIO and the business community, and we would certainly welcome its enactment. Having said that, we recognize the Administration has offered a new proposal that, after the first 2 years, differs significantly from the Portman-Cardin approach. I have been told by experts that the proposal deserves further study and that there may be problems with the yield curve approach for some employers as it would be applied in later years.

According to my advisors, the proposed yield curve approach would drop the current 4-year averaging of interest rates, which could present employers with even greater uncertainty about their cash flow and their budget decisions. In addition, a yield curve could substantially increase pension contributions for employers with relatively older workforces, threatening severe economic hardship for them and their employees.

My purpose here today is not to debate the merits of the two different approaches to the funding issue, and I am certainly not qualified to do so. My purpose is to urge you to act promptly to resolve the uncertainty that businesses such as ours face. One approach that would accomplish the result would be to enact the Portman-Cardin funding mechanism now. That would eliminate the uncertainty. Congress would still have the opportunity to give the Administration proposal careful study and to enact any changes to Portman-Cardin funding rules for 2006 and beyond.

Let me close with the point with which I began. We need to remove the uncertainty in the immediate future. If that uncertainty continues into late October or into November, employers may, in the interim, have taken steps they would not otherwise have taken, and it may have adverse effects on employees and their companies as a whole.

To borrow a phrase from the late football coach, George Allen, on the issue of replacing the 30-year Treasury note, "The future is now." I deeply appreciate the interest of the Subcommittees and am prepared to respond to any questions you might have. Thank you.

[The prepared statement of Mr. Phelps follows:]

Statement of Ashton Phelps, Jr., Publisher, Times-Picayune, New Orleans, Louisiana

Chairmen McCrery and Johnson and members of the Subcommittees, I appreciate the opportunity to participate in this hearing. I am Ashton Phelps, Jr., Publisher of The Times-Picayune newspaper in New Orleans, Louisiana. Our newspaper maintains a defined benefit pension plan to help provide retirement security for approximately 1,000 of our employees and their families. I am glad that these Subcommittees and others in Congress are considering legislation to encourage the use of these types of plans.

In my testimony today, I want to focus on one single issue; namely, the need for permanent replacement for a 30-year Treasury bond rate. This issue is critically important to the economy and the private pension system and immediate action is urgently required.

As you are well aware, employers generally have been required by law to use the 30-year Treasury bond rate to calculate their liabilities under their plans and for certain other purposes. The Treasury Department's aggressive "buyback" of the 30-year bond in the late 1990s and subsequent discontinuation of the bond in 2001, however, have driven rates on these bonds to far below that of other conservative long-term bond rates. These inordinately low rates have inflated our funding obligations far above levels required to secure benefits.

This situation has a significant impact on how employers operate their businesses. Pension fund contributions beyond what is needed to fund future benefits may force employers to divert cash they would otherwise invest in new business opportunities and capital projects that create jobs. Unreasonably high contributions will also force some employers to limit benefit improvements. Finally, the uncertainty now hanging over the pension funding issue will soon force all of us to make next year's budget decisions under a worst-case funding scenario, to the detriment of our business, our employees, and the economy.

Unless Congress moves quickly to put a more realistic pension discount rate in place for 2004, these very substantial cash resources will not be available to help us weather the current economic downturn and grow our business.

We appreciate that Congress has already recognized this problem and allowed employers to use a more realistic discount rate for 2002 and 2003. We also appreciate the leadership of Representatives Rob Portman (R–OH) and Ben Cardin (D–MD) in proposing a permanent solution (Section 705 of H.R. 1776) to this problem and applaud the Administration for embracing the Portman-Cardin approach as a funding benchmark for the next two years.

The pending Portman-Cardin funding proposal permanently replaces the 30-year Treasury bond rate with the rate of interest earned on conservative long-term corporate bonds, directing the Treasury Department to produce this rate based on one or more corporate bond indices. The new rate also applies for other pension calculation purposes, including funding, PBGC premiums and lump sum payments. This approach has broad support and is acceptable to both the business community and the AFL–CIO.

It's critical that Congress include the funding reforms contained in H.R. 1776 in the first available bill that can reach the President's desk. If Congress fails to act promptly, employers will have no choice but to begin soon to manage their businesses under the worst-case scenario I noted earlier. In the uncertain economic climate we now have, employers may have to take steps that would otherwise be unnecessary and undesirable. These steps could include limiting future benefit improvements, reducing capital spending for new plant and equipment, or curtailing spending for research and development.

In the midst of these economic challenges, defined benefit pension plans, voluntarily established by employers, continue annually to provide hundreds of billions of dollars of retirement income to retirees. The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) accounts, have reaffirmed the critical role a defined benefit plan plays in helping us to provide for the retirement security of our employees and their families.

Yet the number of defined benefit plans continues to fall. According to its most recently published annual report, in 2002 the Pension Benefit Guaranty Corporation insured about 32,500 plans, down from a high of 114,400 plans in 1985. Moreover, the agency notes that the number of plans "has fallen precipitously in recent years." This trend is disheartening on a policy and a human level because by offering a monthly benefit for life, many of these plans help ensure that retirees and their spouses will not outlive their retirement income.

Congress should be doing everything it can to encourage the availability of such plans for workers, not creating additional disincentives for employers that voluntarily sponsor these plans. With quick enactment of the Portman-Cardin approach, Congress can help stem this tide.

We recognize that the Administration's recently offered proposal differs significantly from the Portman-Cardin approach beginning in 2006. I have been told by our experts that the proposal deserves further study and that there may be problems with the yield curve approach for some employers as it would be applied in these later years. Chief among these concerns is that a yield curve approach could introduce additional volatility and complexity to the funding rules.

According to my advisors, the proposed yield curve approach would likely use an unknowable "spot rate" instead of a four-year average of interest rates, which could present employers with even greater uncertainty about their cash flow and budget decisions. In addition, a yield curve could substantially increase pension contributions for employers with relatively older workforces, threatening severe economic hardship for them and their employees.

I understand that there may be additional problems with a yield curve approach and that the Administration's new disclosure requirements also raise significant issues. I'm not yet familiar with the intricacies of these issues, but I do know this: Imposing further uncertainty on employers' ability to set budgets and estimate future pension funding obligations will have a negative impact on a pension system that is already in trouble.

My purpose today, however, is not to debate the technical merits of these two different approaches—I'm certainly not qualified to do so—but to urge you to act promptly to resolve the uncertainty businesses such as ours face. Enacting the Portman-Cardin funding mechanism now would eliminate the current uncertainty and provide Congress enough time to give the Administration's proposal the careful study it deserves.

Let me close with the point with which I began and that is that we need to remove the uncertainty in the immediate future. If that uncertainty continues until late October or into November, employers may in the interim have taken steps that they would not otherwise have taken and which may have adverse effects on pension plan participants or on their companies as a whole. I deeply appreciate the interest of these Subcommittees and am prepared to respond to any questions you may have.

Chairman JOHNSON. Thank you, sir. I appreciate your accent. I can understand every word. Dr. Weller, you may begin.

STATEMENT OF CHRISTIAN E. WELLER, PH.D., ECONOMIST, ECONOMIC POLICY INSTITUTE

Dr. WELLER. Thank you, Chairman Johnson, Chairman McCrery, and Ranking Member Andrews for inviting me here today to talk about the President's proposal to change funding rules for defined benefit plans. It is a pleasure to be here.

I am an economist at the Economic Policy Institute in Washington, where I have focused for the last 4 years on retirement issues, including defined benefit plans. Part of my testimony is based on a paper I co-authored with Dean Baker, Co-Director of the

Center for Economic and Policy Research, evaluating a number of pension reform proposals.

Defined benefit plans are an important insurance benefit amid increasingly insecure retirement savings; hence, any proposal to change the pension funding rules should meet, in my view, two tests. It should at least maintain the security of pension benefits and it should promote and sustain sponsorship of defined benefit plans.

I will first comment on the Administration's proposal, which fails on the second goal, and then discuss an alternative proposal that would accomplish both goals especially in the current situation.

In the immediate future, employers need funding relief, as many others have noted. Shifting from the 30-year Treasury rate to the corporate bond rate would offer plan sponsors short-term funding relief. Liabilities would decline on average by 6 to 8 percent.

For the medium term, it is important to make interest rates less volatile to maintain sponsorship of defined benefit plans. Here, the Administration's proposal to use a yield curve creates the biggest problem. Under a yield curve, the length of each liability is matched to the interest rate for a corporate bond rate with a similar maturity. For example, for a benefit that the plan has to pay in 5 years, the discount rate could be the corporate bond rate for 5-year bonds and so on and so forth.

The relationship between short-term and long-term interest rates changes quickly over time, especially for corporate bond rates, which makes interest rates and hence future pension funding hard to predict and creates uncertainty for employers. More uncertainty for employers will make them more likely to bend their pension plans in the future.

Replacing the corporate bond rate with the yield curve creates another problem. Because short-term interest rates are lower than long-term rates, the liabilities that have to be paid sooner, such as benefits to older workers, would be more expensive. Plans with a disproportionate share of older workers would face more rapidly rising costs than other firms when the yield curve is introduced. Workers in mature industries, especially in manufacturing, may be disproportionately likely to lose some of their promised benefits.

When the yield curve will be introduced, the current practice of smoothing or averaging interest rates over a 4-year period would also be eliminated. This averaging makes interest rates less volatile and, thus, pension funding more predictable. Eliminating the smoothing procedure would mean larger swings in contributions which could lead to larger contributions in a recession.

Because interest rates and asset price are typically lower in a recession, when earnings are weak, current rules require more contributions during a recession than during other times. The Administration's proposal offers some short-term relief, but at the cost of additional future headaches for employers in increased retirement income insecurity for workers.

There is a better way of changing funding rules, though. An alternative would be to smooth interest rates over a time horizon that matches the average duration of pension liabilities. Since pension plans have liabilities that come due, on average, after more than 10 years, you can expect to encounter a number of interest rates over the next two decades during which they will invest funds and pay out benefits. The interest rate assumption should match this flow of funds into and out of pension plans, for instance, by averaging interest rates over 20 years instead of just 4 years. The current 4-year average of the 30-year Treasury rate could, for instance, be replaced by a 20-year average of the 10-year Treasury rate.

Such a proposal, if introduced today, would offer even more short-term relief than the Administration's proposal to substitute the corporate bond rate for the 30-year Treasury rate. More importantly, a longer term average would eliminate cyclical fluctuations in the interest rates and, therefore, stabilize funding during recessions.

In our estimates, average contributions from 1952 to 2002 would have been substantially lower than under the current rules while the actual funding ratio would have been higher reflecting a lower probability of fund failure. Consequently, a smoother interest rate would offer employers funding relief right now. It would stabilize employer contributions to pension plans in the future and it would reduce the probability of plan failure, because it would not burden pension plans as much as current rules do during a recession.

Funding rules should be changed so that pension benefits can be secured both in the short-term and for the foreseeable future. To that end, pension rules should allow for less volatility, less uncertainty and more transparency. The Administration's proposal, however, moves exactly in the opposite direction.

In the interest of securing pension benefits amid a rising tide of retirement income insecurity, we need to create less, not more volatility. Thank you very much for your attention.

[The prepared statement of Dr. Weller follows:]

Statement of Christian E. Weller, Ph.D.,
Economist, Economic Policy Institute

Thank you, Chairman McCrery and Chairman Johnson, and members of the committees for inviting me to speak to you today about the Administration's proposal to change funding rules for pension plans. I am an economist at the Economic Policy Institute, where the focus of my research is on retirement issues. My testimony today is partially based on a paper that I have written with Dean Baker, co-director of the Center for Economic and Policy Research, for the Economic Policy Institute.

Pension Funding Needs to Provide Relief Now and Security in the Future

From a public policy perspective, any proposal to change the pension funding rules should satisfy a two-pronged test: (1) it should at least maintain the security of pension benefits; *and* (2) promote and sustain sponsorship of defined benefit plans. With these two goals in mind, I will first comment on the Administration's proposal, which fails on the second goal, and then discuss an alternative proposal that would accomplish both goals.

The discussion over the benchmark interest rate that is used to calculate pension liabilities for funding purposes is not just a technical issue. It has real consequences for the retirement security of millions of Americans, who are facing growing risks in preparing for retirement. Many workers still do not have retirement plans through their employers. For the past three decades, more than half of all private sector workers were not covered by a retirement plan. And those workers who have a retirement plan—particularly a defined contribution plan—face more and more risks with their savings. These risks were poignantly illustrated by the fraud and deception that took place at Enron. At the same time, millions of employees face added insecurities as defined benefits are being put in jeopardy due to the perfect storm of pension funding: Falling interest rates, tumbling asset prices, and a weak economy. Securing defined benefits is an important aspect of reducing the growing insecurities that workers are facing with their retirement savings.

Defined benefit plans are an important source of retirement income for millions of Americans. Professor Ed Wolff calculated in a 2002 report for the Economic Policy Institute that in 1998 46 percent of households near retirement could expect some income from defined benefit plans. That is, a large number of households still rely on this secure insurance benefit. Many defined benefit plans often not only pay retirement benefits, but also survivorship benefits and disability benefits. In a world of increasing uncertainty for workers who are preparing for retirement, such insurance benefits are invaluable assets. Consequently, the goal of any proposal to change the pension funding rules should be to secure promised benefits, while sustaining the system for the future. After all, these promised benefits are deferred compensation that employees already earned and that they count on in retirement.

Three Problems Facing Pension Funding

To secure funding for pension plans, three problems need to be addressed. First, the current benchmark interest rate, the 30-year treasury bond yield, that is used to calculate pension liabilities, needs to be replaced since the Treasury no longer issues 30-year bonds.

Second, the decline of the benchmark interest rate came at a time when pension plans saw their assets tumble amidst a stock market crash and when employers were already struggling due to a weak economy. Thus, pension plans are facing numerous short-term funding pressures. In the interest of maintaining the security of pension benefits, public policy should consider rule changes that will offer plan sponsors short-term funding relief.

The third problem is that the current combination of declining interest rates, falling asset prices, and low earnings is recurring as it typically does in a recession. Consequently, current funding rules create a counter-cyclical funding problem and compound the problem by requiring more contributions during a recession than during other times. In order to promote and sustain sponsorship of defined benefit plans, rule changes should occur in a way that is consistent with more stable funding. This would make it less likely that employers would have to make cash contributions when the economy is weak and they are less able to afford them, and more likely that employers will contribute when the economy is strong and businesses are flush.

Evaluating the Administration's Proposal

The rules proposed by the Bush Administration on July 9 may maintain the security of pension benefits in the short-term, but they exacerbate the long-term risks for pension funding and add new problems to the mix. Thus, they put retirement income security for America's working families further in jeopardy because they put the sustained sponsorship of defined benefit plans at risk. The Administration's proposal envisions the replacement of the 30-year treasury rate with the corporate bond rate for a period of two years, after which it will be permanently replaced by the use of a yield curve. Under a yield curve assumption, the length of each liability is matched to the interest rate for a corporate bond rate with a similar maturity. For example, for a liability that the pension plan has to pay in five years, the discount rate could be the corporate bond rate for 5-year bonds, whereas for a benefit that is payable in 20 years, it could be the rate for 20-year bonds. Lastly, it appears that the Administration's proposal will eliminate the current practice of smoothing interest rates over a 4-year period.

The Administration's proposal addresses the first problem, of course, by replacing the 30-year treasury rate as the benchmark interest rate.

Second, shifting from the 30-year treasury rate to the corporate bond rate would offer plan sponsors short-term funding relief if current smoothing rules were applied. The 4-year weighted average of the corporate bond rate is about 50 to 70 basis points higher than the currently allowable 120 percent of the 4-year weighted average of the 30-year treasury bond rate. For a typical pension plan, this could mean a reduction in liabilities of about 6 to 8 percent. Hence, pension plan sponsors would receive the short-term relief that they are seeking.

However, third, the short-term relief from the Administration's proposal is a trade off against greater risks in the future, which could jeopardize the sponsorship of some defined benefit plans. The proposed new rules create added uncertainties in several ways. For one, the new rules will presumably eliminate the smoothing of interest rates now allowable under the law. Given past experience this could increase volatility of the interest rate assumption by more than 20 percent. Since interest rates tend to fall in a recession, eliminating the smoothing provisions will result in sharper declines of the underlying interest rate and necessitate larger increases in the required contributions.

Further, the Administration's proposed new rules would require companies to use a myriad of interest rates to value their liabilities instead of just one interest rate for all liabilities. Specifically, the Administration believes that the term of the asset that the interest rate is based on should match the maturity of the liability.

Aside from technical questions about which bond rates to use, the proposal creates large uncertainties for plan sponsors since they may have to make assumptions about future movements of not one interest rate, but a wide range of them. The relationship between short-term and long-term interest rates changes quickly over time, and it does so more for corporate bond rates than for treasury rates. The ratio of the corporate bond rate to the commercial paper rate is about 50 percent more volatile than the ratio of the 10-year treasury bond yield to the 6-month treasury bill yield.

Further, economic theory says that short-term rates should be lower than long-term rates. However, during a number of periods there was an inverse yield curve, that is, short-term rates were higher than long-term rates. This makes the yield curve even harder to predict.

Adding more uncertainty to pension plan funding could lead employers, who are already concerned about the complexity of pension regulations, to reduce or abandon their pension promises. Workers would suffer as their future benefits are cut back or eliminated all together.

Another uncertainty arises about the transition from the long-term corporate bond rate to the yield curve after two years. Short-term interest rates are typically, but not always, lower than long-term rates. Pension plans' costs will likely rise—as their assumed discount rates fall—during the transition from a single interest rate to a yield curve. In other words, the respite many employers will enjoy from the replacement of the 30-year treasury rate with the corporate bond rate may be short-lived. As recent events have shown, though, rising costs will provide an incentive for employers to reduce benefits or even terminate plans, undercutting the retirement security for many workers.

Replacing the corporate bond rate with the so-called yield curve creates another problem that could spell greater danger for many workers, especially for those who work in mature industries, such as automobiles. Because the yield curve typically shows lower interest rates for shorter term maturities and higher interest rates for longer term maturities, its use in discounting pension liabilities would make liabilities that have to be paid sooner, such as benefits to older workers, more expensive. Hence, plans with a disproportionate share of older workers would face more rapidly rising costs than other firms when the yield curve is introduced. Consequently, workers in many mature industries, especially in manufacturing, who have already suffered from a prolonged recession in this sector, may be disproportionately likely to lose some of their promised benefits.

To sum up, the Administration's proposal offers some short-term relief, but at the cost of additional future headaches for employers and increased retirement income insecurity for workers.

An Alternative, Smoother Approach to Pension Funding

Does this mean that nothing can be done? Not at all. There is a better way of changing funding rules. As stated earlier, any proposal to change the pension funding rules should at least maintain the security of benefits and promote and sustain sponsorship of defined benefit plans.

A major problem for both employees and employers has been that the current funding rules create a counter-cyclical funding burden, requiring increased contributions, hence a greater likelihood of problems, for plan sponsors during a recession.

An alternative would be to change the rules—to make contributions less volatile and less likely to rise during a recession. In the paper I co-authored with Dean Baker, we discuss three rule changes that would help smooth contributions over time. One of these rule changes addresses the issue of the benchmark interest rate specifically. Our results show that using a smoother interest rate assumption than is currently the practice would reduce the volatility of contributions. It would reduce the required contributions during recessions and increase them during good times, and it would help to improve the overall funding status of pension plans. Put differently, our proposal not only meets the two-pronged test laid out earlier, but it surpasses it. The security of benefits would be improved and adverse incentives for plan sponsors would be reduced.

Current law already allows for some interest rate smoothing in calculating pension liabilities. This provision recognizes that pension plans are a going concern that can expect to receive future contributions, while they are making regular benefit payments. It also recognizes that interest rates can fluctuate quite widely over the course of one or two years. Thus, to stabilize funding for pension plans in a way that will assure the future payment of benefits without unduly burdening employers at any given point in time, the law has permitted some interest rate smoothing.

However, the smoothing of interest rates that is currently allowed still maintains a high degree of volatility. An alternative would be to smooth interest rates over a time horizon that matches the average duration of pension liabilities. The calculations would essentially assume that, during its expected life span, a pension plan will experience interest rates similar to those that prevailed for the past twenty years. To put it differently, since pension plans are going concerns with an average duration of liabilities of well above ten years, they can expect to encounter a number of interest rate scenarios over the next two decades, during which they will invest funds and pay out benefits. The interest rate assumptions should match this flow of funds into and out of pension plans.

Figure 1 shows what different smoothing assumptions would look like compared to the current practice of the 4-year weighted average. The figure shows that averaging interest rates over 20 years would smooth them considerably compared to the current practice and compared to the current market rate. The same is true if the 20-year average of the 10-year rate is taken (figure 2). For instance, the difference between the 4-year weighted average of the 30-year treasury bond yield and the 20-year average of either the 10-year or the 30-year treasury bond yield is about two percentage points. In other words, moving from the current benchmark interest rate to the 20-year average of the 10-year treasury bond yield, for instance, would increase the assumed interest rate by about 1 percentage point, and thus would offer even more short-term relief than the Administration's proposal to substitute the corporate bond rate for the 30-year treasury bond rate.

The choice of the interest rate that will be used for this smoothing practice is determined by a number of factors. In principle it should be an interest rate for a fairly low risk security to reflect the nature of pension benefits. It should be an interest rate that can be easily defined, so as to minimize confusion and improve transparency. And it should be an interest rate where sufficient history is available to allow for the calculation of a long-term average. Clearly a number of interest rates will meet these criteria, but the 10-year treasury rate has the advantage that its long-term average is relatively lower than that of other interest rates, such as the corporate bond rate, thus reducing the chance for underfunding in the long-run.

More important than the choice of interest rate is maintaining or even extending the smoothing of interest rates. A longer term average offers the advantage of eliminating cyclical fluctuations in the assumed interest rates, and therefore stabilizing funding during recessions. In our estimates, average contributions from 1952 to 2002 would have been substantially lower than under the current rules, while the actuarial funding ratio would have been higher, reflecting a lowered probability of fund failure. That is because contributions would have been made during good economic times, allowing funds to build up reserves for the inevitable bad times.

Consequently, assuming a smoother interest rate would address a number of concerns. It would offer employers funding relief from the pension funding difficulties they are currently experiencing. It would also stabilize employer contributions to pension plans, thereby helping to secure retirement income by reducing the risks to this important insurance benefit. In the same vein, it would reduce the probability of plan failure because it would not burden pension plans as much as current rules do during a recession. Hence, plan termination becomes less likely, reducing the expected burden on the Pension Benefit Guaranty Corporation.

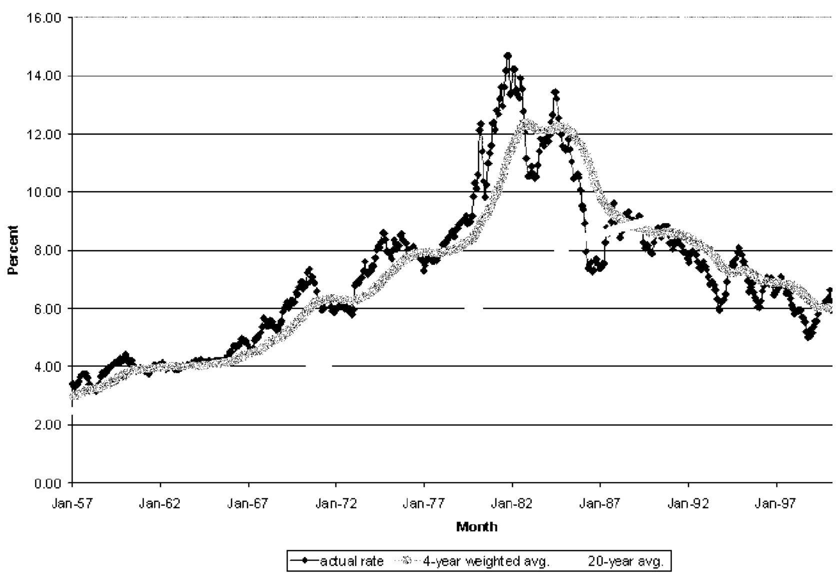
Conclusion

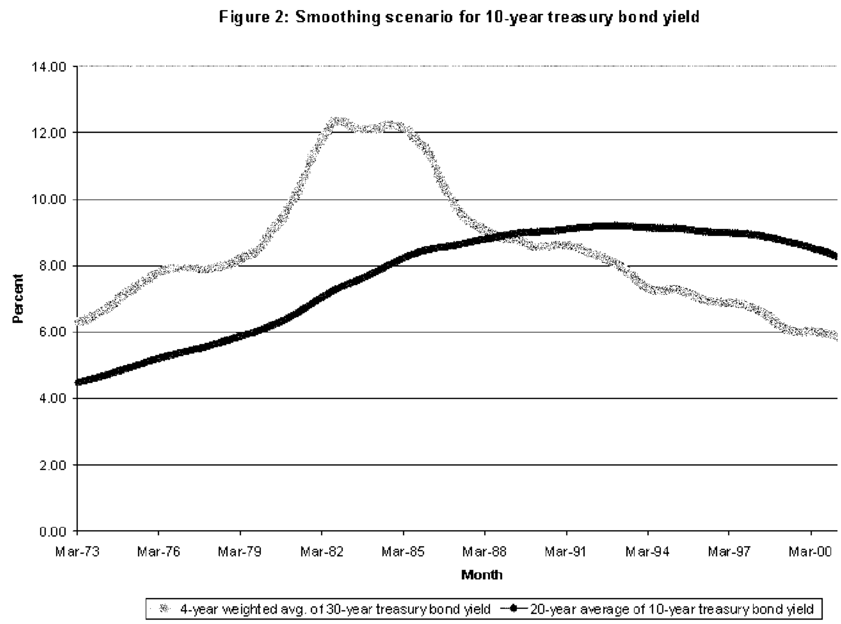
America's workers have increasingly been facing the risks of saving for retirement by themselves. An important part of the retirement plan landscape, defined benefit pension plans, offer them some assurance as they prepare for retirement. However, pension plan beneficiaries have experienced an inordinate amount of uncertainty as funding rules required large additional contributions in the middle of a weak economy and the largest stock market crash in U.S. history. Rather than offering employers the small lifeboat of *ad hoc* relief from this perfect storm, which may jeopardize pension plans in the long term, we need to build a better boat that enables employees, employers, and pension fund regulators to ride out the inevitable rough seas ahead. Funding rules should be changed so that pension benefits can be secured both in the short term and for the foreseeable future. To that end, pension rules should allow for less volatility, less uncertainty, and more transparency.

The Administration's proposal, however, moves exactly in the opposite direction. It makes funding rules more complicated and it adds more volatility to pension funding both by eliminating the beneficial interest rate smoothing that is part of the funding rules right now and by replacing a single interest rate with a widely fluctuating range of interest rates. In the interest of securing pension benefits amid a rising tide of retirement income insecurity, we need to create less, not more, volatility.

Thank you very much for your consideration.

Figure 1: Smoothing scenarios for long-term treasury bond yield





Chairman JOHNSON. Thank you, sir. I appreciate your comments. Chairman McCrery, do you care to question? You are recognized for 5 minutes.

Chairman MCCRERY. Thank you, Mr. Chairman. Mr. Phelps, thank you very much for coming to Washington today to testify. For the benefit of the Members of the two panels, or the two Subcommittees, you should know, Mr. Phelps called me about this issue some time ago; and so I wanted to use that as an example of anybody who calls me that, beware, they may get to testify before a Subcommittee.

Actually, I appreciated the call, as I do from all of my constituents—not that he is a constituent, but he is from my State, because often they bring to Members' attention, problems that we may not know about. So, I appreciated the call.

I also wanted to have on our panel today someone from the real world, so to speak, not that you actuaries are not from the real world, but a real businessperson who has been involved in his particular business for quite some time, as has his family. He is very familiar with the ins and outs of defined benefit programs. They have tried for many years to maintain a good program for their employees, so I wanted to have that perspective today. So, thank you very much, Mr. Phelps, for coming and providing that.

Along that line, we know that your pension plan is facing—or your company is facing problems with respect to your pension plan because of the very low interest rate associated with the 30-year Treasury, and if that were allowed to go forward, you would have to make contributions far in excess of what any reasonable person would conclude would be necessary to properly fund your future liabilities.

Are there any other factors that you can point to that have caused your pension to have problems, your pension program to have problems right now, such as returns on investments, or the general state of the economy? Are there other factors that are contributing to the problems with your pension?

Mr. PHELPS. Thank you, Mr. Chairman. I appreciate the opportunity to be here. I think our plan would be subject to the same influences as those of other companies in this economy. I think we have a particularly strong commitment to our employees. The main point, I would like to be sure is understood today is that this is not a theoretical, long-term issue. This is one in which we need a permanent solution now, because those decisions of that possible exposure on overfunding, or funding that we think is not realistically needed, are dollars that could otherwise go into the economy and capital goods, employee benefits and other ways of running the business.

When you, in our opinion, unnecessarily take those dollars out of the economy, you are making decisions now which can't be corrected and which are going to hurt long-term employees and the economy. That is something that we think should be very much taken into account.

Chairman MCCRERY. So, if we fix the discount rate for contributions, that solves your problems?

Mr. PHELPS. If you get what we feel is a realistic rate and one that seems to be agreed upon, or agreed upon by Democrats, Republicans, business, labor, and what I have heard today coming from the Members of the Subcommittees, it would be fine in terms of our operation.

Chairman MCCRERY. Okay. Thank you. We haven't talked today much about group annuity rates, but back in the 1980s, I guess, when we pegged the 30-year Treasury as a discount rate, there was a lot of talk, evidently, in the record about how we wanted to try to find a "peg rate" that would most closely resemble group annuity rates. Are you familiar with that term and is it still—is it as accurate today as many thought it was back in 1987?

Mr. PORTER. I would argue that there are some problems with that term in that very few large corporations would consider a group annuity contract. They are self-funded self-trusteed plans. I don't think the market exists—I could be wrong—to a sufficient degree to contemplate what is a very, very large plan would look like in the context of a group annuity contract. That would be an interesting exercise.

Group annuity contracts have a place, and they certainly exist, and—but among the larger employers that I tend to be in contact with, it is something we don't relate to.

Chairman MCCRERY. Anybody else on the panel? Well, evidently when the 30-year Treasury was arrived at as the benchmark, there was a lot of discussion about how it resembled group annuity rates, and so maybe it doesn't apply anymore. Maybe it did in the 1980s and not now.

Mr. STEINER. I would say, in general, I agree with Mr. Porter. However, I would say that the bond yield rate has very much a similarity with the group annuity rate, except that it does not include insurance company profits and things of that nature.

Chairman MCCRERY. Yes. Well, those were stripped out. That is why the 30-year Treasury, I think, was arrived at as the benchmark. Mr. Chairman, my time has expired, but I would appreciate a second round.

Chairman JOHNSON. Thank you, Chairman McCrery. Mr. Ballenger, do you care to comment? You are recognized for 5 minutes.

Mr. BALLENGER. Thank you, Mr. Chairman. I know this is water over the dam and all this kind of stuff, but—past history—I owned a small company, and trying to be generous to employees, I put in a defined benefit plan; and everything was going great until along comes ERISA. Once I heard the Federal Government had got into this thing, I knew we were dead.

So, I got scared to death, and I got out from under that and went into an employee stock ownership plan. Of course, it doesn't take long to figure out that the Federal Government was having some likelihood of bothering us there, so I went into—also, to a defined contribution plan with a 401(k). I think Mr. Andrews said it best. This is a—what do you call it—a voluntary benefit of employers.

Now, if you are a new company just starting out, like I was in 1957, and you got to sit there and see all of this crazy stuff going around about pensions and the difficulties that—as you, Mr. Porter, said—the difficulties that are flowing there no matter how we go about this thing, I think the first thing I would do is guarantee that I would never have a defined contribution plan—I mean a defined benefit plan. Defined contribution at least takes care of itself.

The one thing that I wanted to know, I was going to ask Ms. Combs, how many defined contribution plans disappeared after ERISA came along and were created into defined contribution plans? It was just—it would appear to me that the simplest way to solve this problem for any new corporation is, don't have a defined benefit plan, just defined contributions.

You, Mr.—am I being silly, Mr. Porter?

Mr. PORTER. I think you are exactly on point. I don't know the exact number of defined benefit plans when ERISA was formed, something in the 400,000 or 500,000 number seems to ring a bell with me from those days, if my memory serves me correctly.

Back in the 1970s, when ERISA was enacted, companies looked at the balance of a defined benefit plan versus a defined contribution plan. The defined benefit plan provided better income security for employees, and over the long term, because it was a long-term funding arrangement, would do so at less cost to the employer. So, there was a value base for the employer to get into a defined benefit plan. Defined contribution plans, on the other hand, were less volatile and less administrative, but had no guarantees of income for retirees.

Today, with a short-term focus increasingly on defined benefit plans, it becomes questionable about whether a defined benefit plan is, in fact, more cost effective than a defined contribution plan. So, the major benefit to having a defined benefit plan is still income security for employees. All other measures, as far as I can tell, argue in favor of defined contribution plan.

Mr. BALLENGER. Well, I was just thinking a 401(k) seemed to be the most popular thing around today, and if you were beginning from scratch, I think almost anybody would say listen, let's have a defined contribution plan and skip this whole thing.

I just wondered, Mr. Phelps, if you had it to start all over again, and you knew the government was going to get involved in whatever your private efforts were for your employees, would you have looked at it in a different way?

Mr. PHELPS. That is an excellent question. I am sorry. Excellent question. I actually believe that a defined benefit plan is in the longer range—long-range interest of the American worker. I think some of the stock market volatility we have seen in recent years would give good support to that. Many—some workers will invest their funds very well and some will not and some will blow it all in the first couple of years of retirement and some will be prudent about it.

So, I happen to believe that the society is better off and the workers are better off long term with the defined benefit plan. I am here today to ask that you all pass the legislation which makes realistic for those companies that feel as we do to fund such plans and they can fund them realistically and not overfunding them.

Mr. BALLENGER. The only thing that scares me is when I started mine, it was 1957 and now everyone is getting pretty old that was with me to begin with. It has been getting, even on the defined contribution plan, it is getting pretty expensive. So, you don't have control over either plan as far as the future is concerned. Somewhere along the line, knowing that Uncle Sam—I am not trying to put down Portman-Cardin but it is probably a good answer since everybody seems to be in favor of it.

Somewhere down the road it scares me to death to have Uncle Sam involved in something like this, and we might run into the same thing that we have run into right now. I yield back.

Chairman JOHNSON. Thank you, Mr. Ballenger. Mr. Andrews.

Mr. ANDREWS. I would like to thank the witnesses for outstanding testimony. Mr. Phelps, your ringing endorsement of defined benefit plans is welcome. Frankly, it is why many of us have misgivings about the Social Security private option proposals, which is a subject for another day. Let me ask the panelists this: does anyone disagree with the statement that the Administration's proposal introduces too much uncertainty into the calculus by introducing this yield curve. Anybody disagree with that statement? Does anybody disagree with the statement that they are concerned about the 90-day window on the Administration's proposal, I believe, for smoothing rather than the 4 years in present law? Does anybody disagree with that statement? Okay.

If I could then turn the question around, Dr. Weller, we know what you think about smoothing, the 10- or 20-year window would make sense. I think that is a proposal that merits serious consideration. What do the other three witnesses think about that? Smoothing, if I understand it correctly, in layperson's terms, is how many years you get to average in to the rate that you have got to assume for growth of the principal that is in the trust fund for the pension? What do the other three witnesses think is an appropriate smoothing system?

Mr. PORTER. I believe that every company probably has a different view. My company has celebrated its 200th anniversary last year, and next year we will have its defined benefit plan for 100 years. We have been funding it since the 1920s very successfully. We believe in taking the best we can in the interest of our employees and retirees. We have viewed our pension obligation as a long term obligation for 80 years, 100 years, if you include the booking we did during—before we started funding it in the 1920s. It is a very long-term undertaking. A short-term view especially imposed in the moment where we have the 45-year low in interest rates really makes me shudder. Long-term averaging is where we are.

Mr. ANDREWS. Do you think an average in excess of 4 years is worth considering?

Mr. PORTER. As part of a DRC, I really applaud that proposal.

Mr. STEINER. I would like to look at numbers. I'm an actuary. So, I think it is appropriate to study it as part of the proposed restructuring.

Mr. ANDREWS. You find no intuitive objection to a term longer than 4 years? Actuaries are never intuitive, is that your answer?

Mr. STEINER. Thank you. I would suggest that it may be feasible or desirable to have different smoothing rules for those companies that PBGC and the Administration is concerned with, those companies that are not in healthy financial shape. Those companies that are in financially sound shape, it may be reasonable to have 4 years or longer for smoothing, but those companies that are in bankruptcy or with below investment-grade credit ratings, it might make sense to use a different measure for those companies.

Mr. ANDREWS. Mr. Phelps, I don't want to preempt your answer, but I wanted to echo something you said in your testimony about the urgency of getting this done. I have had constituents call me, businesses large and small and express real concern about this that if this problem isn't fixed, they are going to lay people off or they are going to forego some expansion that might put people to work. I share your view that the proposal put forward by Mr. Portman and Mr. Cardin is the right way to fix this. However, given where the Administration is, tell me what you think the shortest extension of the bond rate idea would give you some degree of certainty. In other words, if we had to make a compromise and say we will agree to x number of years and look at something beyond that, what is x in your mind?

Mr. PHELPS. I don't have a specific figure. I would strongly support a permanent change in this regard. We are getting it from all of the Members of the Committee, and you are getting it from business and labor. The people who have looked at it says this is what makes sense, and this is the realistic funding rate for the future. So, I would hope we would get a permanent solution at this time on behalf of employees and companies.

Mr. ANDREWS. I agree with you, and for the record, I would urge the Administration to join this very broad coalition that we have heard expressed today. Realistically, though, I would rather have an intermediate or less satisfying solution right now than I would have no solution at all, and kick back into the problem that we are facing if we don't get something passed.

Mr. PORTER. May I respond?

Chairman JOHNSON. Quickly.

Mr. PORTER. We have been asked by rating agencies to do long-term forecasts of cash flows. When we try to give them a realistic view of what cash flow might be so they can determine our credit rating, their response is, well show us what it would be if Congress fails to act. Show us what it would be. Assets don't earn anything if Congress fails to act. We can't as businesses plan property expansion and jobs with a short-term fix. If there is to be an interim, it needs to be long enough so that when the solution is finally achieved, there is still enough forecast years left so we can have some strategic——

Mr. ANDREWS. I completely concur. A permanent solution is needed here, and I think we have it before this Committee. However, I think an interim solution that fits within the parameters is immensely preferable to inaction, which I think would cause real retardation in the economy.

Chairman JOHNSON. Ms. Tubbs Jones, do you care to comment?

Ms. TUBBS JONES. Thank you, Mr. Chairman, yes, I do. Good afternoon. Mr. Phelps, everybody is talking to you and I was given an assignment. Do you know someone by the name of Alex Macheski.

Mr. PHELPS. I do indeed. He has a defined benefit plan as I do.

Ms. TUBBS JONES. Tomorrow do an editorial in your paper to tell Mr. Macheski what a great Congresswoman he has in me, so he can publish it and repeat it in the greater Cleveland area. I would like to welcome you on behalf of my constituent paper, The Plain Dealer, to our hearing. I am going to skip over the actuarial and then if the Chairman allows me to come back to you, but welcome to all of you.

Mr. Steiner, tell me, or perhaps answer the question that my colleague, Mr. Andrews, asked with regard to what would be the shortest term that we could do an interim fix such that defined benefit plans would not be harmed if there is such a thing?

Mr. STEINER. I am not sure there is such a thing. It depends on whether the economy recovers. I certainly think 2 years is kind of a minimum period, and hopefully the economy will recover and this will not be as significant an issue after the 2-year period, but who knows.

Ms. TUBBS JONES. That is what we said in 2001. You talked about in your testimony that in 2002 alone, Fortune 1000 plans sponsored to contribute $43.5 billion. In 2003, they are going to contribute some $83 billion; are these unusually large funding requirements attributable to the interest rate assumption or are there other contributing factors?

Mr. STEINER. It is hard to say what the basis is for plan sponsors to make contributions. The interest rate is a factor in their decision, but other factors also come into play—whether to make contributions to not have to pay PBGC variable rate premiums, or in particular, some companies are making contributions because they can afford to or some companies are making contributions because they want to avoid accounting charges. So, the decision on whether to make a contribution is not solely a function of the interest rate that we are talking about. However, changing the interest rate as suggested in Portman-Cardin would provide companies with significant flexibility. The companies may not use that flexibility, but it would provide them with significant flexibility.

Ms. TUBBS JONES. I ran out of time on your answer. Dr. Weller, give me a shorter answer—same question.

Dr. WELLER. What was the question?

Ms. TUBBS JONES. What impact does the aging population have on the funding requirements that companies are required to pay in?

Dr. WELLER. Can you repeat the question? I completely froze there.

Ms. TUBBS JONES. Am I scaring you? The question I asked, are there large amounts of dollars that have been put into programs over the last 2 years? In Mr. Steiner's testimony, there were huge amounts of the dollars that were put in. I asked were those funding requirements, do they come as a result of change in interest rates? Let me change it a little bit for you. In the Administration proposal, there was some discussion about limiting the ability of companies to make payments into funding when the times are good. What is your position on that, sir?

Dr. WELLER. First of all, as Mr. Steiner said, it is hard to distinguish on an aggregate what the major contributions to the funding problems are. Clearly the declining interest rate is one of the major ones. Clearly the other one is we have seen large decreases in asset prices, the largest in the history of the United States. I think the first point I want to make about this——

Ms. TUBBS JONES. It has to be a short point.

Dr. WELLER. Combination of falling asset prices and falling interest rates always a curse in a recession or most recessions. It will reoccur in the next one too, and most likely in the next one too. The next one, yes, there is a problem that pension funds were not allowed to contribute or were discouraged from making contributions when times were good, and I think we need to take that really seriously under consideration, whether we allow plans to make contributions or eliminate the discouragement that is currently on the books.

Ms. TUBBS JONES. Mr. Phelps, Mr. Porter, what other than this 30-year Treasury bond would cause you two, who have had long-term defined benefit plans, to change your position about providing defined benefit plans to your employees?

Mr. PHELPS. For us, the issue is much more the allotment of dollars by forcing us as one with a defined benefit plan to overfund it, in our opinion, and as generally agreed, one then is prevented from improving other benefits, from allocating capital and ways to improve business and help the American economy. It does not make sense, and I would urge the Congress not to send the message to those who have or might consider defined benefit plans that they are going to have to overfund them when there is the agreement there that we have heard here today in terms of a standard which is an adequate funding standard. You simply are discouraging people from having or going into these plans if you will not adopt a permanent solution.

Ms. TUBBS JONES. Can I get a quick answer from Mr. Porter, Mr. Chairman.

Chairman JOHNSON. You are getting your money's worth.

Mr. PORTER. I think all of the factors feed into it: assets, liabilities, demographics, the economy, and the fact that our Nation is becoming more a part of a global economy and less of a stand-alone national economy. We have to compete with worldwide competition, and to the extent that we penalize companies before doing the right thing, that has an economic impact.

Ms. TUBBS JONES. Thank you, Mr. Chairman.

Chairman JOHNSON. Mr. Kline, do you care to comment?

Mr. KLINE. Yes, thank you, Mr. Chairman, and thank you, gentlemen for coming in today. I am not an actuary and perhaps not intuitive either, so I find this extremely complicated and fairly confusing. I wanted to cut to a couple of short questions, if I could, and I am not sure who even to ask them to, so I will start by asking all of you. Mr. Andrews opined that he thought it was better to have an interim solution rather than no action by Congress, and I think we assume that you agreed—could you tell me do you agree with that, an interim solution is better than no action?

Mr. PORTER. I think no action a very serious issue.

Mr. PHELPS. I would say it is a serious mistake not to get a permanent solution now given the agreement we have heard.

Mr. KLINE. Right, but again, assuming that we could not get a long-term solution, you would prefer to have an interim solution to no solution? I had someone from Minnesota come into my office and express concern about the difference between multi employer defined benefit plans, and, perhaps, single employer. In this particular case, the employer was in the trucking business and part of many trucking companies that are contributing to, I think, a Teamsters defined benefit plan. The discussion here today about what to do about the 30-year Treasury, would that apply equally to the two situations, a single employer and multi? Do you have a comment on that?

Mr. STEINER. The funding issues for multi employer plans are similar, and therefore, the interest rate would apply to them as well.

Mr. KLINE. So, is there general agreement that the approach you would take for one would apply to the other?

Mr. STEINER. Yes.

Mr. KLINE. Thank you very much, Mr. Chairman, I yield back. Mr. Portman, I reckon you ought to have a word or two. Do you care to comment?

Mr. PORTMAN. Of course, Mr. Chairman.

Chairman JOHNSON. You are recognized.

Mr. PORTMAN. Anybody who has intuition wouldn't be able to understand this pension system. Your question—I guess I have a couple of things, Mr. Chairman. One is, I like what Mr. Steiner said about setting the parameters here. I know there are reporters who were here earlier who had to leave, and I talked about this a lot in the public forum. It doesn't always get communicated somehow, but could we talk a little bit about liabilities? When we hear numbers as we did earlier today about billions of dollars, $300 billion and so on, what is that based on?

Here is my point: the 30-year Treasury is used to calculate the pension liability that reporters like the Washington Post this morning and others write about in their editorial. What is the impact of the 30-year Treasury as compared to something like a long-term safe corporate bond or some other rate that would be a more realistic rate?

Mr. STEINER. Using methodology that is an approximation, because it can only be an approximation, we determined that for 2004 and 2005, the extent of possible overstatement of contribution requirements by using the 30-year Treasury as opposed to a blended corporate bond yield, as you have suggested, would be as much as $115 billion over a 2-year period.

Mr. PORTMAN. Can you give us a sense of what percentage that is as compared to the reduction of value of assets and reduction of interest rates overall? How much does the 30-year Treasury contribute to that?

Mr. STEINER. As indicated in the testimony, we indicated that for 2004 and 2005, if the law is not changed, contributions might be in the neighborhood of $160 billion by the Fortune 1000 companies for the 2-year period 2004 and 2005. By comparison, under Portman-Cardin, that amount would be $45 billion. Now we are not suggesting that sponsors would actually reduce their contributions to that extent, but that is the relative magnitude of the overstatement of using 30-year Treasuries.

Mr. PORTMAN. Overstatement of the liabilities. That is even larger than I thought as a percentage. Even if it is 30 percent or 40 percent, that is a significant difference. I think it is important as we lay out, what is the problem what are trying to get at, which obviously is an issue of PBGC having a potential to have a run on its assets and having the taxpayer picking up the tab at the end of the day. We need to keep in mind that part of this is an analysis of liabilities, which is based on an accurate measure. You can look at different ones, but if you look back at 25, 50 or 75 years as Mr. Phelps said earlier, it is a conservative measure.

Mr. Porter talked about an interim period being long enough so that we have enough time left to plan. I talked earlier about earlier planning, certainty and predictability and the importance of that not just to this issue, but to keeping jobs in general, and what do you think the interim would have to be in order to leave enough time?

Mr. PORTER. If I had to pick an interim, I would have a variable length, so that once final decisions are made, it will have some delayed impact. It may not be politically plausible, but that is the issue. When our chairman has to decide whether to build a plant, that is a long-term financial undertaking, and if he doesn't have certainty around the pension funding, he has to be more cautious on that decision.

Mr. PORTMAN. So, you would like to see an interim period that is long enough, but then once there were an adjustment to something else, it would have to be a transition.

Mr. PORTER. That is right.

Mr. PORTMAN. The Treasury Department has promoted, as you know, a 2-year corporate rate, and then a transition over another 3 years to a yield curve analysis. We don't have all the details on that yet, and they are still fleshing that out, but it would probably be a 90-day averaging. Is that adequate or not adequate?

Mr. PORTER. My preference would be if there was an interim period, that it be locked into the corporate bond rate. That if a decision is made in the context of what our Nation's long-term retirement income policy should be that we should go to something like a yield curve, and it be enacted as a separate piece. I would oppose enacting something now that we don't have any details on.

Mr. PORTMAN. Would you also say there are other factors that are related to the issue of what the discount rate ought to be, for instance, the actuarial assumptions and mortality rates we talked about earlier, or are those unrelated? Can you legislate on one without dealing with the other issues, the other funding issues or even accounting issues?

Mr. PORTER. I think you need to focus on the whole package, what is it we are trying to accomplish with funding in the first place and protecting our participants. Also if you look at transparency, that is an issue that has been raised several times, current law says that assets are allocated on a termination basis to retirees first and then to eligible to retire and so on. It doesn't make a lot of sense to talk about transparency on the liability side without matching it to assets. I think you need to look at the whole funding and liability and asset picture before we make a decision on one piece of it.

Mr. PORTMAN. My time is up. I have some additional questions for the record, if that is okay.

Chairman JOHNSON. Sure. Would you all be willing to answer questions that are posed after this testimony? Thank you, I appreciate that. Mr. Andrews.

Mr. ANDREWS. Thank you. Very briefly, Mr. Steiner, I wanted to echo something Mr. Portman just said. Would you state again your best estimate of the difference between the contributions that would be required next year if the law were not changed and what you think it would be under Mr. Portman and Mr. Cardin's proposal.

Mr. STEINER. We haven't estimated that on a 1-year basis, but on a 2-year basis. We estimate that if the law is not changed, contributions to the plans would be in the neighborhood of $160 billion. We also indicated if sponsors base their contribution decision just solely on the higher interest rate anticipated under Portman-Cardin, the total contributions for the 2-year period would be in the neighborhood of $45 billion, but we are not suggesting that planned sponsors——

Mr. ANDREWS. I understand.

Mr. STEINER. This is a measure of the overstatement of the 30-year Treasury rate.

Mr. ANDREWS. It is a plausible point that if we were not to take this step, that we would see the effective withdrawal from the economy over a 2-year period of $100 billion of salaries and wages, new plant and equipment, and other far more stimulative spending. We spend months around here arguing about an economic stimulus package that wasn't much larger than that when you break it down on a year-by-year basis.

As I said earlier, it would be truly ironic if after a mighty attempt to create some stimulus for the economy, that we, by default, permitted this depressant effect to take place in the economy. This is a very important point. I yield the balance of my time to my friend from Ohio.

Ms. TUBBS JONES. Thank you, Mr. Chairman and Mr. Andrews. I want to go to the yield curve. As I understand it, as the proposal from the Administration, you would—when we change or should we change from 30-year Treasury bonds to corporate bond ratings, then companies would ultimately be forced to invest in instruments required to fit that short-term investment. My question is would they be precluded from investing in equity instruments such as stocks?

If they are, what would be the effect on the stock market in the long-term? Finally, how would you reconcile this approach on the discussion about having people on Social Security investing their money in the stock market? Short question.

Dr. WELLER. Well, let me say the first thing about interest rates because they came up here. I think what is important to keep in mind is what will affect pension plan contributions or pension plan funding is changes in interest rates, not levels. So, moving toward a yield curve would actually exacerbate the problem because you have not only one interest rate, but multiple interest rates changing and thereby obviously changing contributions in unpredictable ways. As it is my understanding, the yield curve would only affect the liability side. It would have no effect on the asset side. I am not sure—maybe some of the actuaries could contribute.

Ms. TUBBS JONES. You are saying because it won't have an effect on the asset side, it means they could invest in stock markets?

Dr. WELLER. They could invest in the stock market. I think overall actual investments, advisory boards, pension funds look at the overall portfolio and expect the rate of return that they are assuming in trying to beat that market or that assumption. Whether they think they can get that from a stock market at any given point in time or from the bond market, I think, depends on the overall situation.

Ms. TUBBS JONES. I am done. I thank you very much. Mr. Porter, real quick.

Mr. PORTER. I think there—while it can voluntarily invest in equities, there will be a natural pressure to match assets and liabilities so that the volatility on the corporate balance sheet is minimized, and I think it will pull hundreds of millions of dollars out of equities, and I don't know that the fixed income market can handle it right now.

Chairman JOHNSON. You got your full value.

Ms. TUBBS JONES. Know that I appreciate it.

Mr. ANDREWS. I would ask unanimous consent that a letter to you, Chairman Johnson from the AARP, be entered into the record dealing with the question of lump sum distribution.

[The information follows:]

AARP
Washington, DC 20049
July 14, 2003

Hon. Sam Johnson
Chairman
Subcommittee on Employer-Employee Relations
2181 Rayburn House Office Building
Washington, DC 20510

Hon. Jim McCrery
Chairman
Subcommittee on Select Revenue Measures
1135 Longworth House Office Building
Washington, DC 20510

Dear Mr. Chairman:

We commend you for holding this timely joint hearing with the Subcommittee on Employer-Employee Relations on the Administration's proposal to improve the accuracy and transparency of pension information.

The Administration has proposed an ambitious plan to improve the accuracy of the pension liability discount rate, increase the transparency of pension plan information and strengthen safeguards against pension underfunding.

The Administration's proposals to increase the transparency of pension plan information and enhance safeguards against pension underfunding merit careful review by the Subcommittees.

In particular, AARP urges that you reject the recommendation that the 30-year Treasury rate be replaced with rates drawn from a corporate bond yield curve, or other changes that would unfairly reduce benefits. This recommendation and other similar legislative proposals pending before the Committees would reduce by as much as one-third the lump sum payments that millions of Americans are eligible to take from their employer's pension funds when they retire, change jobs, or are laid off.

We request that you include as part of the record of this hearing this letter and the attached report prepared by AARP's Public Policy Institute (PPI) entitled "Increasing the Pension Discount Rate Would Cut Benefits." This report documents and illustrates the potential impact of replacing the 30-year Treasury rate with a composite corporate bond rate on lump sum payments. As illustrated on Table 1 of the report, the use of a composite corporate bond rate to calculate lump sum benefits would reduce the lump sum benefits for a 45-year old by 24.2 percent relative to current law, compared to a 16.5 percent cut for a 55-year old and 8.1 percent for a 65 year old.

AARP would oppose any proposal to unfairly change plan funding rules that would reduce single-sum retirement benefits for millions of employees in defined benefit pension plans. As your committees and the Congress consider substitutes for the 30-year Treasury interest rate and related changes to these pension provisions, we urge you to protect and preserve participant's benefits, including single sums and annuities. While it is appropriate to review the use of the 30-year Treasury rate for funding purposes, the law should maintain a more conservative rate for determining the value of benefits paid in a single sum.

We recognize the need to enact a replacement for the 30-year Treasury rate. The Treasury decision to discontinue the 30-year bond, in combination with other economic factors, has pushed rates on these bonds to a level below other conservative long-term bond rates. These trends, in combination with generally low interest rates (including the 30-year rate) and a weak stock market are currently imposing added funding pressures on employers that sponsor defined benefit plans. It is appropriate for Congress to address these funding pressures.

However, American workers too are feeling the pressure of falling rates and a weak market. These financial trends have also dramatically lowered both the savings and retirement account balances and the expected returns that working families have been counting on for a more secure retirement. A survey conducted by AARP last year among 50–70 year-old investors showed that 77 percent of the group who lost money in stocks reported that their losses have altered their lifestyles, work plans, or expectations about retirement. About 27 percent of the respondents who reported stock losses have either postponed retirement, returned to work in retirement, started to look for work, or are considering taking one of these steps as a result of their losses.

In addressing employer funding concerns, Congress should not compound the hardship faced by individuals by changing the law to reduce guaranteed benefit amounts. At a minimum, Congress should retain an interest rate for determining single-sum benefit amounts that is consistent with the historical level of the 30-year Treasury rate. This can be done by maintaining the traditional relationship or spread between the current statutory single-sum rate and any higher market rate that may be selected for funding purposes. (e.g., use the higher corporate bond rate minus 100 basis points, or use 85% of the higher corporate bond rate for purpose of the lump sum calculation).

In addition, to the extent that legislation prescribes any new single-sum interest rate benchmark, even one that attempts to replicate the traditional spread for the 30-year Treasury rate (after adjusting for the effect of Treasury debt reduction, buy-backs and discontinuance of the 30-year Treasury bond), fundamental fairness to employees dictates that any change be phased in very gradually.

If Congress concludes that it requires more time and analysis to give adequate consideration to the pros and cons of the Administration's yield curve funding rate proposal versus the Portman-Cardin funding rate proposal, it may find it prudent to extend current law (as in effect for 2002–2003) for an additional 2 years, as the Administration has previously proposed.

We appreciate the opportunity to share our views with your Subcommittee on this important and timely subject.

Sincerely,

Michael W. Naylor
Director of Advocacy

Attachment

AARP Public Policy Institute

Increasing the Pension Discount Rate Would Cut Benefits

Many defined benefit pension plans give retiring or terminating employees the choice of receiving their benefits in the form of a single cash payment (a "lump sum" distribution) instead of a series of regular payments. Plans generally determine the amount of a lump sum distribution based on the present value of the future stream of payments that represents the pension the employee has earned. To calculate the present value, plans use a legally required discount rate designed to prevent lump sum values from being understated.

The discount rate used can make a significant difference in the amount of the lump sum benefit, with a higher discount rate producing a lower benefit. The benefit cut is deeper for younger individuals because of the effect of discounting over additional years.

To figure the amount of a lump sum payout, the law has required use of a discount rate that is at least as favorable to employees as the interest rate on 30-year Treasury bonds. (This lump sum discount rate has been different—generally lower—than the interest rate plan sponsors are allowed to use to determine how much they must contribute to fund their plans.) But Congress now is considering alternatives to the 30-year Treasury discount rate, because Treasury has stopped issuing 30-year bonds.

Figure 1 presents calculations of lump sum benefits using the Treasury 30-year bond rate and a composite corporate bond rate. The composite corporate bond rate is an average of the high-quality long-term bond indices of Lehman, Moody's, Merrill Lynch, and Salomon.

The percentage differences in lump sums produced by using the Treasury 30-year bond rate and the composite corporate bond rate are presented in Table 1.

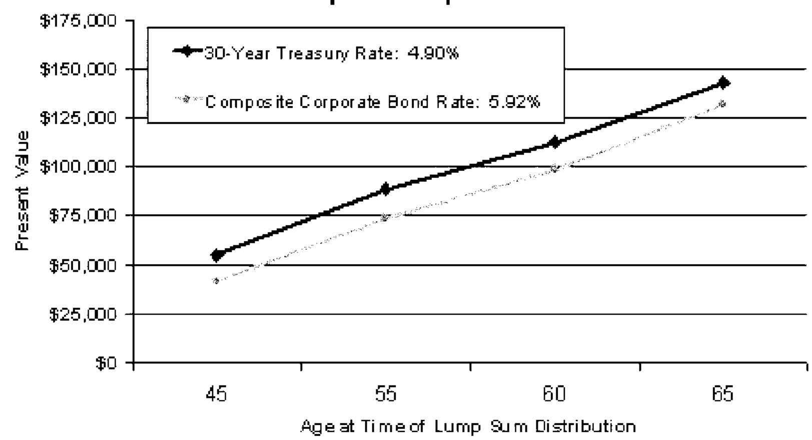
The figures in the chart and the table assume that the lump sum paid at the age on the horizontal axis replaces a monthly annuity benefit of $1,000, payable starting at age 65. The lump sum benefit is the result of a present value calculation. All figures were provided by the American Academy of Actuaries.

Workers of all ages would receive a lower lump sum benefit from calculations using a high-quality long-term corporate bond rate than they receive under current rules that employ the 30-year Treasury bond rate. Thus, a 65-year-old would receive a $142,700 benefit under current law, which uses the Treasury 30-year bond rate, but using a composite corporate long-term bond rate would reduce this benefit by 8.1% to $131,200.

The impact of using a corporate bond rate to calculate lump sum distributions would be greater for younger workers. Thus, using the composite corporate rate would reduce lump sum benefits for a 45-year-old by 24.2% relative to current law, compared to a 16.5% cut for a 55-year-old.

A change from the 30-year Treasury bond discount rate would not affect the benefit of plan participants who choose to take their pension in the form of an annuity instead of a lump-sum payment.

Figure 1. Lump Sum Distributions:
Present Value Using the 30-Year Treasury and Composite Corporate Bond Rates



Data source: American Academy of Actuaries. Calculations based on unisex mortality tables, a monthly benefit of $1,000 and rates as of April 2003. Composite corporate bond rate is the average of High Quality Long-term Bond Indices of Merrill Lynch, Salomon, Moody's, and Lehman. Present values for ages prior to age 65 are based on interest only and do not consider any subsidies. These and other factors may produce very different results based upon a particular plan's provisions.

Table 1.

Percent Reduction of Lump Sum Distribution if the 30-Year Treasury Bond Rate is Replaced with the Composite Corporate Bond Rate

Age at Time of Lump Sum Distribution	Percent Change
45	−24.2%
55	−16.5%
60	−12.4%
65	−8.1%

Data source: American Academy of Actuaries.

Chairman JOHNSON. Without objection, so ordered. I would like to ask a question about blended rates. One, I think, Mr. Porter, you said that defined benefit plans or rules haven't kept up with the changes in economy in the last 5 years. Would a blended corporate rate to replace a 30-year Treasury enable plans to keep up with future changes, and what do you think of a blended rate, for how long?

Mr. PORTER. Talking about the blended rate as in Portman-Cardin?

Chairman JOHNSON. I think the gentleman from Louisiana would have understood me.

Mr. PORTER. I think that goes a long way to helping the situation. It would be helpful to understand where we want to go as a Nation. I articulate a long term retirement policy, but I think that really, really helps, and I think we need to have it as long as possible, preferably permanent. I don't believe we are going to have interest rates stay where they are forever. This is hopefully a short-term volatility. When interest rates return, that will be returning back to normal funding, and this will be what it was intended to be, a stop-gap measure.

Chairman JOHNSON. If we have to do a temporary measure, would you think maybe a blended rate for 5 years would work?

Mr. PORTER. That would certainly help.

Chairman JOHNSON. All of you agree with that?

Mr. STEINER. Could I just make a comment that the last 3 years of investment experience would stress a program with the current design using blended rates as well. We have just faced the perfect storm, as you indicated. We believe that the rules should be revisited and some kind of incentive should be given to employers to fund more during the good times and not as much as during the bad. We have just been through a situation where it is shown the rules, as they currently exist, do have some flaws, even with the replacement of a corporate bond rating.

Chairman JOHNSON. Appreciate that. Do you have a comment?

Dr. WELLER. The term "perfect storm" has been used—we used it in the title of our paper. I want to caution here that this is not a unique situation. We show in the paper that the combination of falling asset prices and falling interest rates and weak earnings recurs in most recessions, and I think that needs to be taken into consideration when we rewrite the rules that we get this right for the future.

Chairman JOHNSON. Thank you, sir. Chairman McCrery, you care to question?

Chairman MCCRERY. Yes. Thank you, Mr. Chairman. I don't want to be the skunk at the party here, but I think it is incumbent upon some of us, one of us, to point out that there is not unanimity, as my good friend from Louisiana has said several times. Yes, business, yes, organized labor agree, but they have their own different reasons for agreeing. I should point out that the Bush Administration, through the Treasury Department, the Department of Labor, and the PBGC, disagree with the rate as stated in the Portman-Cardin bill. So, it is not as simple as you are saying well, we all agree, so let us do it. Evidently, in a prior time in 1987, I go back to 1987 when this issue was squarely in front of policymakers, a different decision was reached. The blended corporate bond rate in 1997 was not equal to the 30-year Treasury rate, was it?

Mr. PORTER. It was very close.

Chairman MCCRERY. Was it higher or lower?

Mr. STEINER. I believe it was a little higher, but nowhere near the spread that currently exists today.

Chairman MCCRERY. Should we look exactly for something that is exactly what the 30-year Treasury was in 1987? The Administration has said in their proposal, let us use the Portman-Cardin blended corporate bond rate. That is their proposal, but they say let us take into account the varying liabilities, pension plan to pension plan, according to that plan's makeup, its workforce, its retiree force. What is wrong with that? Leave aside the complexity and all that. In concept, what is wrong with that?

Mr. PORTER. When the work was done in 1987, this was intended to be a backstop against normal funding. It wasn't intended to be the absolute of funding. What I am hearing in the form of a yield curve sounds like a replacement for normal funding. To the extent that it is a fundamental change in the way plans are funded, that debate needs to take place. To the extent that we could view it as the drop-in replacement for 30-year Treasuries, which I don't, then your arguments would be well regarded. I just think it is not a drop-in. I think it is a fundamental change and we need to understand fully the complexity and consequences of that change before it is adopted.

Chairman MCCRERY. I agree. We need to fully understand what we are doing, and we may have to have some more hearings.

Mr. STEINER. The Administration's proposal focuses on a plan termination like liability. It is not a plan termination liability, but it is like one. We can talk about whether it is confusing to give participants both pieces of information, because that will indeed be confusing. The Administration's focus is really on protecting plan participants in those companies that are not financially strong.

As a matter of fact in their proposal, they indicate 90 percent of the companies whose pension plans had been trusted by the PBGC, had junk bond ratings for the entire 10-year period before termination. We agree that it is probably reasonable to focus on those companies when designing rules that look at plan termination liability and really require accurate measurement of those liabilities. We are not so convinced that it is absolutely necessary to saddle the rest, the 85 percent of the other good plan sponsors with the strict rules, and this focus on plan termination liability when they are perfectly able to provide benefits on plan termination.

Chairman MCCRERY. I am not sure that the Administration is as inflexible as you paint them. In fact, I think you will find, and if you were to have further discussions with them, that they have thought about including in their final proposal which we don't have yet, but flexibility for funding that could solve some of the concerns that you have expressed. Quickly, talk about lump sum distribution. Should we apply the same rate, discount rate for pension funding as we do to lump sum distributions?

Mr. PORTER. I think ultimately what is used for lump sums needs to be fair and equitable for the participants and the plans. Plan sponsors that put in lump sum options did so on the belief that they would be paying out an equitable lump sum present value of the benefit that the individuals would have received if they had taken the annuity. To the extent that the rates that are currently in use are paying out a disproportionate amount of assets versus what would be reasonable for a long-term annuity, then the pension plans are being drained and we are worrying about the PBGC and the adequacy of the PBGC. I think we have to be concerned that we do a balanced approach to lump sums, and whether that is the same or some percentage of the same that is close, that needs to be debated, but I think it is fair and equitable.

Mr. STEINER. To the extent that 30-year Treasury bond uses a low interest rate, using the 30-year Treasury bond to determine lump sum distributions overstates the value of those distributions. It is a policy question as to whether we should be encouraging lump sum distributions and defined benefit plans. I agree with Mr. Porter that when these plan sponsors initially adopted lump sum distributions, interest rates were relatively close to their long-term expectations. So, they thought that granting a lump sum distribution was kind of a cost neutral situation. The law requires them to continue paying distributions and the interest rates have dropped a lot and so plans are being drained, and this is a concern to plan sponsors.

Chairman MCCRERY. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Chairman McCrery. As you can hear we have a series of four votes, and so I want to thank you all for participating today. I appreciate all of you being here and taking the time out. I think we have had an excellent discussion, both with you and the previous testimony. So, we appreciate your presence and your testimony. Thank you so much. The hearing will stand adjourned.

[Whereupon, at 5:10 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the Allied Pilots Association, Fort Worth, Texas

The Allied Pilots Association (APA), the union representing the 16,000 pilots and retired pilots of American Airlines, strongly endorses the *intent* of Congress and the Administration to strengthen and improve pension security. However, we believe that the HR 1776 and Administration's proposal do not adequately address the needs of pension plan participants. To provide adequate protection and security, APA recommends the following actions:

- Extend the sunset provisions as enacted in section 405 of the Job Creation and Workers Assistance Act of 2002 through 2005 to allow time for a careful analysis to derive a universal alternative applicable to all defined benefit plans
- Disassociate the liability discount rate from the lump sum discount rate since pension plans invest for capital *accumulation* and retirees invest for capital *preservation*
- Develop a universal rate for all pension plans to use for liability that recognizes a pension plan's funding horizon
- Use 120% of the rate used by the Pension Benefit Guaranty Corporation ("PBGC") for calculating lump sums (the rate was required prior to the change to the 30-Year Treasury under GATT)
- Require all companies to disclose the value of their pension plan assets and liabilities on a termination basis in their annual reporting using the market value of assets (not the actuarial value of assets)
- Require plan sponsors and their controlled groups to properly fund their pension obligations before making contributions to or providing benefits under non-qualified arrangements for corporate executives (e.g., non-qualified supple-

mental executive retirement plans, stock plans, incentive programs, bonus arrangements, etc.)
- Allow pension plan sponsors and their participants to jointly address pension funding issues without imposition of benefit limitations or reductions from the federal government.
- Eliminate the provisions of Article 3 of the Administration's proposal

While there is no disagreement that the pension security of Americans participating in defined benefit pension plans has eroded significantly over the past few years, neither the proposal nor HR 1776 appear to provide the level of security on which so many participants will depend upon in their approaching retirement years. The Administration's proposal fails in the following respects:

- Matching the interest discount rates to the term structure of plan liabilities will most likely increase pension costs for companies experiencing economic hardship
- It fails to recognize the distinction of risk for the retiree versus the plan sponsor when setting the discount rate for valuing lump sum distributions
- It fails to place limitations on sponsors of underfunded pension plans while restricting pension accruals of plan participants (e.g., there are no restrictions on contributions to non-qualified executive plans or other similar benefits)
- It encourages plan sponsors to file for bankruptcy protection by providing a significant reduction in the pension obligations eroding the pension security of their employees
- It fails to adequately recognize the obligations of plan sponsors to provide the negotiated benefits under their working agreements with labor

The following responds to each of the points (shown in quotes) in the Administration's proposal in the order presented:

1. **Improving the Accuracy of the Pension Liability Discount Rate**:

"Accuracy is essential because too high a rate leads to underfunding, putting retirees and taxpayers at risk. Too low a rate causes businesses to contribute more than is needed to meet future obligations, overburdening businesses at this early stage of the recovery."

APA agrees with Congress, the Administration and corporate America that there is a need to replace the use of the 30-Year Treasury as the interest discount rate for pension purposes since the sale of new 30-Year Treasury securities has ceased. This lower than market rate significantly inflates the pension liabilities and the amount plan sponsors must contribute to adequately fund their pension obligations.

The Administration's proposal addresses two specific areas of concern, pension funding and lump sum payments for participants. APA's comments and recommendations for each of these points follows.

Use of Appropriate Yield Curve Discount Rate

"The Administration recommends that pension liabilities ultimately be discounted with rates drawn from a corporate bond yield curve that takes into account the term structure of a pension plan's liabilities. For the first two years, pension liabilities would be discounted using the blend of corporate bond rates proposed in HR 1776 (Congressmen Portman and Cardin). A phase-in to the appropriate yield curve discount rate would begin in the third year and would be fully applicable by the fifth year. Using the yield curve is essential to match the timing of future benefit payments with the resources necessary to make the payments"

- ***This method will most likely increase pension obligations for plan sponsors experiencing economic distress.*** While the details of the yield curve model are not clear, it appears the model attempts to match the term of the liabilities with an appropriate corporate bond yield. Thus, plans that have longer expected term liabilities would use a longer-term yield rate and plans with shorter expected term liabilities would use a shorter-term yield rate. Generally, plans with a younger workforce and fewer annuitants would have a longer-term liability expectation than plans with an older workforce and many annuitants.

  In times of economic distress, one of the first steps that a company takes is to reduce its workforce. Companies generally achieve these reductions through layoffs and/or retirement incentives. Layoffs are generally based on longevity, primarily affecting younger employees and older retirees accept retirement. Both of these conditions reduce the expected liability term and, under the proposal would require the use of a lower discount rate based on a shorter-term yield curve. A lower discount rate would potentially significantly increase the plan's liability. As a result, such a company would face potentially higher pension costs during a period when it could least afford them.

This method defeats the goal of simplicity. While the Administration's proposal hopes to make the process simple and easy, the proposal would not achieve this goal in the following situations:

- *Companies with multiple defined benefit pension plans would have multiple discount rates for each plan.* While each plan's discount rate would be based on that plan's expected liability term, the use of multiple rates would greatly complicate the Administration for that company. For example, American Airlines has five defined benefit pension plans; thus, under the Administration's proposal, American would have up to five different discount rates.
- *The use of a plan specific discount rate would significantly differ from the current FAS 87 liabilities as reported on corporate balance sheets.* FAS 87 was established by the accounting profession as a means to standardize pension expense among various companies. It established a uniform methodology to be applied across all corporations. Since each plan would have its own discount rate, the results of the funding valuation and its liability determination would vary significantly from the FAS 87 valuation. This is greatly complicated should the company have multiple pension plans.

RECOMMENDATION: Extend the sunset provisions as enacted in section 405 of the Job Creation and Workers Assistance Act of 2002 through 2005 to allow time for a careful analysis to derive a universal alternative applicable to all defined benefit plans.

Phase in Use of Yield Curve for Lump Sums

"Currently, lump sums are valued using a lower rate than that used for pension funding, draining pension plans' assets whenever lump sums are paid. In order to protect the retirement security of both those who have not yet retired, and those who have chosen to take benefits as an annuity, the Administration proposes that ultimately, lump sums be discounted by the same rate used for other pension liabilities. In order to avoid disrupting the plans of workers who will receive benefits in the immediate future, lump sums would be computed using the 30-year Treasury rate as under current law in years one and two. In the third year a phase-in to the appropriate yield curve discount rate would begin. By the fifth year lump sums will be discounted by the same rate used for other pension liabilities."

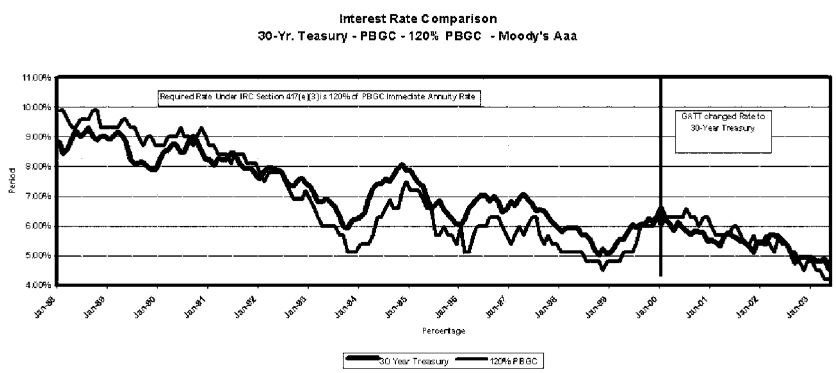
- ***Linking the interest discount rate for a plan's liability determination to the rate used to determine lump sum distributions forces a retiree to take on greater investment risk than is prudent.*** A distinction should be made between the rate used to determine both a pension plan's funded status and the rate used to determine the lump sum payment to a retiree for the following reasons:
- *Retirees Have Fewer Resources to Recover From Losses.* Retiree's have little time to recover from an investment loss or down market. Their lump sums must provide the primary source of income for the remainder of both the retiree's and spouse's life. As a result, financial planners universally recommend portfolios designed to preserve capital at the expense of higher investment returns to avoid the potential for irrecoverable losses. This differs significantly from a pension plan's investment objective to accumulate wealth. Since such portfolios designed to preserve capital trend toward low-risk to no-risk investments, the discount rate used to determine the lump sum should be a risk-free rate.
- *Retiree's Financial Security May Be Jeopardized.* To use the same interest discount rate for both the liability determination and for lump sum determinations, forces the retiree to take on more risk than may be prudent in order to obtain the same economic value of the benefit. For example, if the lump sum was determined using a rate of 8%, the retiree must obtain a return of 8% for each year throughout retirement to get the same economic benefit. This may require him or her to invest a larger portion of the lump sum in higher-risk equity investments than is prudent for his or her age. In addition, each 1% point increase in the interest rate reduces a retiree's lump sum by approximately 10%.
- *Pension Plans Can Tolerate The Higher Risk Associated With Higher Investment Returns.* Unlike retirees, pension plans can tolerate a riskier investment mix for the expected higher returns since the corporations that sponsor these plans can offset losses from corporate revenues. Many defined benefit plans use an investment mix of equities and fixed income (typically 60%/40%, respectively) to yield expected annual returns of 8%–10%. Thus, for the purpose of determining a

plan's funded status a higher rate that reflects the expected higher returns is appropriate.

- ***The Administration's Proposal asserts that using a lower interest rate than used for pension funding drains pension plan assets.*** This proposal fails to focus on the cause of the underfunding. The Administration's proposal focuses on the discount rate used to determine lump sum distributions; instead, the focus should be on the plan's actuarial assumptions since it is the actuarial assumptions, not just the liability discount rate, which determines the funded level of a plan. Plan sponsors have great latitude in setting and adjusting the actuarial assumptions to compensate for all forms of benefit payment and plan experience. The plan sponsor and actuary are jointly responsible for setting actuarial assumptions that reasonably reflect plan experience and expectations. The plan sponsor is responsible for ensuring that that plan is appropriately funded to meet the benefit payments promised to retiring participants. Thus, the plan sponsor should ensure that reasonable actuarial assumptions are established that consider all aspects of plan design, demographics and experience.

RECOMMENDATION: Use 120% of the rate used by the PBGC for calculating lump sums ("Historical Rate", the rate required prior to the change to the 30-Year Treasury under GATT).

- *The Historical Rate Compares Favorably to the 30-Year Treasury Rate.* The Historical Rate is the rate that was required by law prior to the change to the 30-Year Treasury. From 1988 through 2002, the median for the 30-Year Treasury was 6.79% compared to 6.3% for the Historical Rate. The median rates for calendar year 2002 were 5.40% and 5.25% for the 30-Yr Treasury and the Historical Rate, respectively.
- *The PBGC rate is the rate used to determine the value of lump sums.* The PBGC has established a discount rate used for determining the value of a participant's benefit. The Historical Rate is based on the PBGC rate. The following chart shows the monthly difference between the 30-Year Treasury and the Historical Rate from 1988 through 2002.



2. Increasing the Transparency of Pension Plan Information.

Disclose Plan Assets and Liabilities on a Termination Basis

"The Administration proposes that all companies disclose the value of pension plan assets and liabilities on a termination basis in their annual reporting. Too often workers are unaware of the extent of their plans' underfunding until their plans terminate, frustrating workers' expectations of receiving promised benefits."

APA agrees with this proposal and further recommends that this information be provided to all plan participants in the annual summary annual report.

Disclose Funding Status of Severely Underfunded Plans.

"The Administration proposes that certain financial data already collected by the PBGC from companies sponsoring pension plans with more than $50 million of underfunding should be made public. Publicly available information would include the assets, liabilities and funding ratios of the underfunded plan, but not confidential employer financial information. This data is more timely and accurate that what is publicly available under current law."

APA agrees with the requirement that corporate financial information such as pension assets, liabilities and funding ratios of the underfunded plan be disclosed, but that other information such as contributions to, and payments from, non-qualified benefits and compensation programs also be disclosed to the public.

Disclose Liabilities Based on the Duration-matched Yield Curve of Corporate Bonds

"The Administration proposes that companies annually disclose their liabilities as measured by the proposed yield curve before duration-matching is fully phased in for funding purposes. By providing this information before the new discount rate is effective, workers and the financial markets will have more accurate expectations of a plan's funding obligations and status."

This proposal is particularly puzzling. Most defined benefit plans invest 60%–70% in equities and 30%–40% in fixed income. Duration matching of only 30%–40% of the portfolio seems to entirely ignore the larger position and greater impact of the equities. This proposal begs further explanation and details.

3. Strengthening Pension Funding to Protect Workers and Retirees

Firms with Below Investment Grade Credit Rating

"When firms with junk bond credit ratings increase pension benefit promises, these costs stand a good chance of being passed on to the pension insurance system, frustrating the benefit expectations of workers and retires and penalizing employers who have adequately funded their plans. Under the Administration's proposal, if a plan sponsored by a firm with a below investment grade credit rating has a funding ratio below 50 percent of termination liability, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth), and lump sum payments would be prohibited unless the employer contributes cash or provides security to fully fund these added benefits. In an analysis of over half of PBGC claims, 90 percent of companies whose pension plans have been trusteed by the PBGC had junk bond credit ratings for the entire ten year period before termination."

The Administration's stated intent of this provision is to protect workers and retirees by strengthening pension funding. While APA supports this as a noble endeavor, the proposals suggested do not provide protection for workers or retirees and do not address a process to adequately strengthen pension funding.

The Administration's proposal is to place severe limitations (e.g., freezing benefit accruals, prohibiting benefit improvements and eliminating lump sum payments) if a plan's funding ratio falls below 50% of termination liability. APA has the following concerns regarding these proposals.

- ***This proposal fails to allow employers and employees to jointly address the problem.*** By enacting such a law, the federal government has deprived the employer and his employees from considering other alternatives to address the problem (such as, wage reductions, reduction in future pension accruals, etc.). In many cases, this will have the effect of unilateral elimination of negotiated pension benefits.
- ***Fails to recognize other causative factors.*** In many cases, pension underfunding is the result of a number of other inter-related events such as Stephen Kandarian's "perfect storm" which caused most of America's defined benefit pension plans to become significantly underfunded when just a couple of years before they were adequately to over-funded. To impose such drastic actions for a temporary condition harms both workers and retirees.
- ***Change to the Termination Basis for Measuring Plan Funding Level is not Fair to Plan Participants or Sponsors.*** In prior years, most Companies have maintained their defined benefit plans at adequate funding levels. The funding level has been measured using the Actuarial Accrued Liability method since this method assumes that the pension plan will be an on-going concern, which is a qualification requirement. To abruptly change the measurement from the conventional Actuarial Accrued Liability measurement used by many companies to measuring liabilities on a Termination basis will cause many, if not most plans, to fail to meet this standard and require immediate imposition of the benefit reductions. This is not fair to plan participants or plan sponsors.
- ***Fails to Recognize the Responsibility of the Plan Sponsor to Ensure the Financial Stability of the Plan.*** The plan sponsor has the responsibility to ensure that the plan, through investment returns and contributions, has the assets available to pay the promised benefits as they become due. This proposal places severe restrictions on the benefits of plan participants, with no requirements or penalties on the plan sponsor. At a minimum, the plan sponsor should

be prohibited from establishing or contributing to any non-qualified benefit program or providing any non-salary compensation (e.g., stock options, incentive compensation, bonuses, deferred compensation, etc.) established for executives until the pension plan funding level exceeds 80% on a termination basis and all frozen, suspended or forfeited benefits are restored under the terms of the plan as they existed prior to the benefit reductions under the Administration's proposal.

- ***Fails to Describe What Happens to a Plan whose Funding Ratio Rises above the 50% Level.*** While the Administration's proposal describes the benefit reductions that apply to a plan that falls below the 50% level, there is no provision describing what happens when a plan's liabilities again exceed the 50% level.

RECOMMENDATION: APA recommends that this portion of the Administration's proposal be eliminated for the reasons cited above.

Firms in Bankruptcy

Same restrictions as above plus PBGC's guaranty limit would be fixed as of the date the plan sponsor files for bankruptcy

The Administration's proposal would impose the benefit reductions recommended above in addition to reducing the maximum benefits to the level provided by the PBGC when a company files for bankruptcy. APA disagrees with this proposal for the following reasons:

- ***Many Companies who file for Bankruptcy Emerge with no Impact to their Defined Benefit Plans.*** In many cases, bankruptcy is caused by temporary adverse economic conditions. Companies many times emerge from bankruptcy. Not every bankruptcy leads to trusteeship of a defined benefit plan by the PBGC. Thus, to impose the PBGC termination provisions on the pension plans of any company that files for bankruptcy fails to recognize this possibility and is punitive to the plan participants. In addition, this would apply even to plans that were 100% funded on a termination basis. In this case, the plan would have assets significantly in excess of the liabilities calculated under the proposed reductions.
- ***The Requirement to Impose these Benefit Reductions Fails to Allow Employers and their Employees and Creditors to Consider All Alternatives to Address the Problems Causing the Bankruptcy.*** The reasons are the same as stated above. By enacting such a law, the federal government has deprived the employer and his employees and creditors from considering all alternatives to address the problem (such as, wage reductions, reduction in future pension accruals, etc.). In many cases this will have the effect of unilateral elimination of negotiated pension benefits.
- ***Motivates Employers to File for Bankruptcy.*** If enacted, this provision would provide employers with another reason to file for bankruptcy since through such a filing an employer could reduce or eliminate a pension cost that he was unsuccessful in negotiating through the collective bargaining process. This provision provides no incentive for an employer to increase the funding of the pension plan or address other issues that may be contributing to the bankruptcy.

RECOMMENDATION: APA recommends that this portion of the Administration's proposal be eliminated for the reasons cited above.

To summarize, while APA agrees with the intent of Congress and the Administration to strengthen and improve pension security of the millions of plan participants covered under defined benefit pension plans, APA believes that the Administration's proposal and HR 1776 do not adequately address the needs of pension plan participants. To provide adequate protection and security, APA recommends the following actions:

- Extend the sunset provisions as enacted in section 405 of the Job Creation and Workers Assistance Act of 2002 through 2005 to allow time for a careful analysis to derive a universal alternative applicable to all defined benefit plans
- Disassociate the liability discount rate from the lump sum discount rate since pension plans invest for capital *accumulation* and retirees invest for capital *preservation*
- Develop a universal rate for all pension plans to use for liability that recognizes a pension plan's funding horizon

- Use 120% of the rate used by the Pension Benefit Guaranty Corporation ("PBGC") for calculating lump sums (the rate was required prior to the change to the 30-Year Treasury under GATT)
- Require all companies to disclose the value of their pension plan assets and liabilities on a termination basis in their annual reporting using the market value of assets (not the actuarial value of assets)
- Require plan sponsors and their controlled groups to properly fund their pension obligations before making contributions to or providing benefits under non-qualified arrangements for corporate executives (e.g., non-qualified supplemental executive retirement plans, stock plans, incentive programs, bonus arrangements, etc.)
- Allow pension plan sponsors and their participants to jointly address pension funding issues without imposition of benefit limitations or reductions from the federal government.
- Eliminate the provisions of Article 3 of the Administration's proposal

The Allied Pilots Association has long valued the pension programs that it has negotiated for our members and stands ready to assist in any way possible to ensure the pension security for our members and the American public.

Statement of the American Federation of Labor and Congress of Industrial Organizations

The AFL–CIO, on behalf of its affiliated unions' 13 million members, appreciates the opportunity to express our views on proposals to replace the interest rate on 30-year Treasury bonds as the benchmark interest rate for various pension funding rules and related requirements under the tax code and ERISA.

Employment-based pensions are an essential component of a strong national retirement system. Unions have long supported defined benefit plans as the soundest vehicles for building and safeguarding retirement income security, as they are federally insured and provide a guaranteed monthly lifetime benefit. As a result, seven-in-ten union workers in the private sector (compared to fewer than one out of every seven non-union workers) participate in defined benefit plans. Millions of union members now count on negotiated pension benefits when they reach retirement.

The Employee Retirement Income Security Act (ERISA) sets specific funding requirements for defined benefit plans aimed at ensuring that plans have sufficient assets to meet promised benefits over the long run. ERISA also provides that defined benefit pensions are to be insured through the Pension Benefit Guaranty Corporation (PBGC), and plans are to pay premiums to the PBGC to finance its insurance program.

Several pension funding rules require the use of interest rates based on the interest rate on 30-year Treasury bonds. Congress chose the 30-year Treasury bond rate for funding purposes because it believed it was an accurate and appropriate proxy for group annuity purchase rates.[1] Most significantly, the rate on 30-year Treasury bonds is used to measure single-employer pension benefit promises for purposes of the minimum funding rules and the determination of variable rate premiums owed to the PBGC. Therefore, that rate has an important impact on how much single-employer pension plan sponsors have to contribute to their funds and the level of premiums they are required to pay to the PBGC.

The Treasury Department's decision to stop issuing 30-year Treasury bonds early last year, however, has undermined the funding objectives prescribed by Congress when it selected the interest rate on 30-year Treasury bonds as the underlying benchmark. The Treasury Department's decision to stop issuing 30-year Treasury bonds means that the interest rate derived from those bonds is artificially low and no longer an accurate proxy for group annuity purchase rates. In response, Congress enacted a temporary change in the rules to allow plans to use a higher interest rate, but one still based on the 30-year Treasury bond[2], for purposes of the minimum funding requirements and the PBGC variable rate premium.

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[1] General Accounting Office, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, pp. 4–5 (February 2003).

[2] For purposes of measuring current liabilities under IRC section 412(l), Congress raised the ceiling on the interest rate corridor from 105% to 120% of the four-year weighted average of the 30-year Treasury bond rate. For purposes of determining the PBGC variable rate premium,

The AFL–CIO believes that Congress should prescribe a replacement for the rate of interest on 30-year Treasury bonds for those purposes. It is imperative that Congress selects a permanent rate now to promote the stability of defined benefit plans. **The following guidelines should inform Congress's decision-making in determining the new rates:**

First, Congress's objective must be limited to selecting the right replacement rate. This means choosing a rate that will yield plan funding sufficient to protect workers' accrued benefits if a plan terminates. Any other objectives, such as addressing the short-term pension funding pressures resulting from significant stock market declines and historically low interest rates, should be addressed through other tools.[3]

Second, the interest rate that replaces the 30-year Treasury bond rate should approximate group annuity purchase rates. Such a rate is consistent with Congress's original intent, and it reflects the cost of buying benefits in the private market if a plan were to terminate, therefore providing appropriate protections for workers and beneficiaries. The rate could be based on Treasury securities, an index or indices of high-quality long-term corporate bonds, or a composite of both in combination with an appropriate adjustment factor if necessary to approximate group annuity purchase rates. Legislation should preclude any requirement that interest rate basis be related to the duration of plan liabilities or be taken from a yield curve.

We are troubled by the Bush Administration's proposal to replace the 30-year Treasury bond rate permanently with rates taken from the corporate bond yield curve. This would effect a radical change in the underlying pension funding rules and have troubling consequences for workers, retirees and the future of defined benefit plans. Current pension funding rules are predicated on the use of a single, smoothed interest rate to measure all liabilities. The Administration's proposal would require each plan to use many different discount rates with no meaningful smoothing.

Mandating the use of a yield curve, as the Administration has proposed, threatens to destabilize the voluntary defined benefit pension system. The Administration's yield curve proposal introduces substantial volatility into pension funding requirements because it eliminates the four-year weighted average smoothing of current law, relies on thin bond markets to determine rates for specific maturities, introduces the risk of an inverted yield curve and requires discount rates to change with what could be sudden changes in workforce demographics. All of these factors, which can translate into unpredictable plan contribution requirements, likely will weigh heavily on companies' willingness to continue to sponsor defined benefit plans. The predictability of a company's contributions is particularly important when comparing defined benefit plans to 401(k)s and other defined contribution plans. In the latter type of plan, companies not only can establish much more predictable contributions but also easily eliminate their contributions during economic downturns, as a number of prominent companies have done recently.

Additionally, although the yield curve has been advertised as a way to improve the measurement of plan liabilities, it would not result in a more accurate measurement of plan liabilities and particularly would penalize many mature companies and their workers. The Administration's stand-alone yield curve mandate ignores other critical factors that determine the size and duration of a plan's liabilities. Most significantly, this approach neglects to account for the impact of certain critical differences in the mortality rates of plan participants on the measure of liabilities. An extensive study of the mortality of individuals covered by pension plans clearly shows that there are significant differences in mortality rates between blue-collar and white-collar workers. In fact, whether an individual is an hourly or salaried worker is a more important predictor of mortality at age 65 than gender. Failure to incorporate the use of collar-based mortality adjustments in the Administration proposal penalizes a great many plans because their participant populations are relatively mature and predominantly blue collar. As a result, the Administration's proposal would distort the measurement of their liabilities. This would have troubling consequences, in particular, for workers at manufacturing companies, many of which already are under enormous financial stress. It is worth noting that the manufacturing sector has lost more than two million jobs in recent years.

We believe it is critically important that Congress act now to provide an appropriate replacement for the 30-year Treasury bond rate, which protects the security

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Congress raised the ceiling on the interest rate corridor from 85% to 100% of the applicable annual interest rate on 30-year Treasury bonds.

[3] Congress should examine, separately, interactions between the current funding rules and the historically low interest rates and three consecutive years of stock market losses that pension funds are enduring.

of workers' pensions while promoting and maintaining the stability and sponsorship of defined benefit plans.

We greatly appreciate the opportunity to present our views on this important matter.

Statement of the American Society of Pension Actuaries, Arlington, Virginia

The American Society of Pension Actuaries (ASPA) appreciates this opportunity to submit its views in connection with this joint hearing that has been called to examine pension security and defined benefit plans, with a special focus on the Bush Administration's proposal to replace the 30-year Treasury rate as the benchmark for calculating required contributions to defined benefit plans and lump sum payouts from defined benefit plans.

ASPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPA's membership is diverse, but united by a common dedication to the private pension system.

We applaud the Subcommittees and the full Committees for their leadership in exploring these important issues. We also commend the Subcommittees and the full Committees for their demonstrated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers.

The Yield Curve: Further Details, Further Study

Comprehensive Review Required

On July 7, 2003, the Administration announced significant proposals to change some of the rules for funding single-employer defined benefit plans. The proposals as they are currently available are summarized below. However, it is important to note that at this stage, Treasury is still working on some important details. The centerpiece of the plan is a proposal to replace the 30-year Treasury bond rate as an interest rate benchmark for purposes of calculating the deficit reduction contribution and lump sum distributions with a corporate bond interest rate based on a yield curve (*i.e.,* a duration-matched discount rate).

ASPA congratulates the Administration for its willingness to address these important issues. Specifically, ASPA welcomes the Administration's acknowledgement of a corporate bond rate as conceptually an appropriate replacement for the 30-year Treasury bond rate.

ASPA is currently studying the Administration's proposals. Until all of the details are revealed, it is difficult to reach ultimate conclusions. After further review, ASPA may very well conclude that a yield curve approach, appropriately refined, is a reasonable approach to replacing the 30-year Treasury bond rate. However, ASPA strongly believes that a significant change to the funding rules, such as the yield curve proposal, should only be considered in the context of a complete review and possible additional revisions respecting the overall funding rules.

ASPA's initial conclusion is that while a yield curve approach may be more theoretically correct, as the Administration asserts, there are other aspects of the funding rules that likely could also be refined to be more theoretically correct. ASPA believes all these elements should be examined together, comprehensively.

For example, mortality tables could certainly be updated. It may be appropriate to allow plans to use mortality tables that are better tailored to the specific demographics of the plan. For example, H.R. 1776, the new pension reform bill introduced by Representatives Rob Portman (R–OH) and Ben Cardin (D–MD), would permit the use of "blue collar/white collar" mortality tables in certain circumstances. Further, duration matching concepts might be appropriate for purposes of asset valuation. Similarly, asset smoothing techniques and amortization periods for experience gains and losses probably should be reconsidered. Additionally, there is a need to discuss rules that would allow plan sponsors to better fund their plans in advance when they have the resources to do so. ASPA is in the process of examining these and other issues.

A critically important aspect of any overall review of the funding rules must also include consideration of the potential impact on defined benefit plan coverage. Defined benefit plan coverage in this nation is threatened. Some three quarters—75 percent—of our nation's workforce is not covered by a defined benefit plan. Although some of these workers, if they are fortunate enough, are at least covered by a defined contribution plan, like a 401(k) plan, most of the nation's workforce does not enjoy the security of a guaranteed level of post-retirement income.

Recent stock market declines clearly highlight the difference between a defined benefit plan and a defined contribution plan, in which participants bear the risk of investment losses. According to a recent study by the Employee Benefit Research Institute, a three-year bear market immediately prior to retirement can significantly reduce income replacement rates generated by 401(k) plan accounts. This is not an issue for defined benefit plans, which provide a guaranteed monthly retirement benefit for employees. A defined benefit plan's guarantee of a specific level of post-retirement monthly income provides a strong retirement policy justification for encouraging defined benefit plan coverage. Consequently, any defined benefit plan funding reform and related proposals must carefully balance potentially expected burdens against perceived benefits. In fact, given the importance of promoting defined benefit plan coverage ASPA believes that any proposed increased burden on defined benefit plans must be justified by a compelling policy rationale.

Interim Benchmark Should Replace 30-Treasury Rate Until Completion of a Comprehensive Review of Funding Rules

In the July 7 proposal, the Administration indicates that it supports comprehensive funding reform and is currently reviewing the appropriateness of current mortality tables. It is also considering possible incentives for more consistent annual funding requirements. However, Treasury says it views these issues as follow-up issues, a second step to follow enactment of the yield curve proposal. By contrast, ASPA believes these issues should be considered together, so that the potential for their combined effect on defined benefit plan coverage can be examined. Consequently, ASPA believes the yield curve rules should not be instituted before consideration of other possible changes to the funding rules.

Thus, it is ASPA's view that a 4-year weighted average corporate bond rate should be enacted as a substitute for the 30-year Treasury bond rate. This interim approach should endure for several years, until a formal study can be conducted to develop proposals for comprehensive funding reform. In fact, ASPA would suggest a joint Administration/Congressional commission, with private sector input, to study all pension funding reform issues.

ASPA believes the interim 4-year weighted average corporate bond rate measure should be based on the provision included in H.R. 1776, the Portman-Cardin pension reform legislation. The relevant provision in H.R. 1776 would replace the four-year weighted average 30-year Treasury bond rate with a four-year weighted average corporate bond rate. Treasury would determine the rate, using a blend of indices reflecting high-quality long-term corporate bonds. The Portman-Cardin provision would also apply a spot corporate bond rate to lump sum distributions. The spot corporate bond rate would begin in the third year after enactment, and would be fully phased in over the subsequent five years. ASPA suggests applying a similar provision to any short-term measure in advance of comprehensive funding reform.

Further, ASPA supports the Portman-Cardin provision to fix the interest rate at 5.5 percent for calculating the lump sum Internal Revenue Code Section 415 defined benefit limit. ASPA encourages Congress to enact this provision immediately. This provision is particularly important to ensure sounder funding of small business defined benefit plans. ASPA strongly urges that the fixed 5.5 percent rate for calculating the lump sum 415 defined benefit limit be included in any defined benefit plan funding legislation enacted by Congress this year.

Congress has been considering a replacement for the 30-year Treasury bond rate for some time. Presently, for purposes of the deficit reduction contribution, plans can use up to 120 percent of the 4-year weighted average of 30-year Treasuries. However, this rate is scheduled to revert to 105 percent after the 2003 plan year. Thus, it is critical that Congress act to address this issue this year.

Summery of Bush Administration Proposals [1]

Funding and Lump Sum Changes

For purposes of calculating the deficit reduction contribution (DRC) under Section 412(l) the 4-year weighted average 30-year Treasury bond interest rate would be replaced with a “yield curve discount rate” which would be fully phased in after four years. Beginning with the 2004 plan year and ending with the 2005 plan year, a 4-year weighted average of a corporate bond rate would be used. Treasury would determine the rate by blending various high-quality corporate bond indices reflecting bonds of maturities of at least 20 years. Beginning with the 2006 plan year, two-thirds of current liability for purposes of the DRC would be determined using this corporate bond rate and one-third would be determined using a yield curve. For purposes of the 2007 plan year, these percentages would flip. For the 2008 and later plan years, the current liability would be determined entirely based on the yield curve. It is important to note that the yield curve would not reflect 4-year weighted averages, and would be, to some degree, a spot rate.

Although the technical details of the proposal have not been released, it is our understanding that the yield curve would be applied to projected future cash flows, which would then be discounted using an interest rate based on the yield curve. In other words, each year’s projected future cash flows would be discounted using a different interest rate. The actual mechanics of this have not yet been ironed out. The Administration is asking for broad regulatory authority to address the details. ASPA believes that it would be overly burdensome, if not impossible, to value every participant’s benefit individually and thus some averaging techniques must be allowed.

Calculation of lump sums would be done using the same rules as current law for the 2004 and 2005 plan years (*i.e.,* the spot 30-year Treasury bond rate). For the 2006 and 2007 plan years, a phase-in between the 30-year Treasury bond rate and a yield curve approach similar to the one described above for purposes of calculating current liability would apply. For the 2008 and later plan years, lump sums would be calculated entirely under a yield curve approach. Thus, the interest rates for workers electing lump sum distributions closer to normal retirement age will be lower (and thus more valuable) than for younger workers.

The Administration’s proposal does not address the issue of the interest rate used for purposes of determining the defined benefit plan limit under Internal Revenue Code Section 415 for a lump sum distribution. ASPA urges both Congress and Treasury to establish a fixed rate—5.5 percent would be appropriate—for this purpose.

Increased Disclosures

Beginning with the 2004 plan year, all plans would have to disclose the value of plan assets and liabilities on a termination liability basis in their summary annual report. It is unclear under what basis termination liability would be measured for this purpose.

ASPA has concerns about this termination liability disclosure proposal, particularly the burden it would place on plans that are otherwise well funded. It is further unclear what is accomplished by this proposal, given that such disclosure and notices are already required to be given to plan participants in the case of under funded plans under Title IV of ERISA. ASPA believes the very real burden that would be imposed on plan sponsors by such a disclosure rule would substantially outweigh any perceived benefit of such a rule in terms of additional information to participants.

Beginning with the 2004 plan year, plans required to submit financial data to the PBGC under ERISA Section 4010 would have to make available to the public, upon request, a certain amount of such information respecting the plan. The specific information that would be required has not yet been specified.

[1] The Administration’s proposals as announced only apply to single employer plans and have no impact on multiemployer plans. The proposals were announced in the form of a white paper and there is some likelihood that, in addition to further technical details, items discussed in the proposal may change.

Beginning with the 2006 plan year, plans would have to disclose in the summary annual report their current liability (for purposes of the deficit reduction contribution) determined entirely based on the yield curve.

Benefit Restrictions for Severely Underfunded Plans with a Threatened Plan Sponsor

Where (1) a plan's funding ratio falls below 50 percent of termination liability (probably using a Title IV standard) and (2) where the plan sponsor has a junk bond or similar credit rating or the plan sponsor has declared bankruptcy, the plan would no longer be able to accrue additional benefits (no accruals from additional service, age, or salary growth plus any benefit improvements) and would no longer be able to pay lump sums unless the plan sponsor contributes cash or provides security to fully fund the added benefits or lump sums. This is a restrictive rule—perhaps overly restrictive—for those plans subject to it, although it is unclear how many plans would be affected. The restriction on lump sums can be seen as punitive from the standpoint of innocent participants who suddenly lose the ability to elect a lump sum distribution, particularly from a threatened plan. In addition, ASPA believes that there are tens of thousands of defined benefit plans maintained by plan sponsors who have not issued bonds and thus do not have a bond credit rating. ASPA encourages both the Administration and Congress to consider alternative credit standards for such plans. ASPA would be pleased to further discuss this issue and our accompanying concerns with the key policymakers in this process.

Other Funding Reforms

Finally, the Administration indicates that it is also reviewing other possible defined benefit plan funding reforms. The July 7 proposal states that Administration personnel are considering "the proper establishment of funding targets, appropriate assumptions for mortality and retirement age, and incentives for more consistent annual funding." ASPA concurs that these issues merit further study and recommendations for modification, and believes such study and recommendations should come before the establishment of a yield curve to replace the 30-year Treasury rate as the benchmark rate for defined benefit plan calculations. ASPA disagrees with the Administration's insistence that its yield curve proposals should be enacted immediately, before consideration of these other possible reforms. ASPA strongly urges Congress to undertake the necessary comprehensive review of all pension funding rules before enactment of significant reforms.

Summary and Conclusion

ASPA believes the Administration's yield curve proposal for establishing a new and better benchmark interest rate for purposes of calculating the deficit reduction contribution and lump sum distributions holds some promise as the best way to solve the current pension funding crisis confronting defined benefit plan sponsors. However, ASPA strongly believes that pension funding issues are crucial to an employer's decision to establish a defined benefit plan—and that defined benefit plans are superior mechanisms for providing retirement income security to our nation's workers. Consequently, ASPA believes it is necessary to conduct a comprehensive review of all pension funding issues prior to the enactment of a permanent change to the benchmark interest rate.

At the same time, however, ASPA knows it is imperative to establish a new benchmark interest rate to replace the 30-year Treasury bond rate. Because Treasury has stopped issuing 30-year bonds, the 30-year bond interest rate no longer works as a viable measure for calculating pension funding issues. Any failure to establish a stable replacement rate threatens employers' ability and willingness to continue their defined benefit plans.

Accordingly, ASPA urges Congress to enact an interim replacement benchmark rate. ASPA supports the long-term corporate bond rate mechanism contained in H.R. 1776 as the appropriate interim rate. Further, ASPA supports the formation of a Congressional-Administration-Private Sector commission to study and make recommendations on overall pension funding issues, prior to the enactment of a permanent replacement benchmark rate. ASPA believes there is potential for the Administration's yield curve proposal, but that further study—both with respect to still-undetermined and important details of how it would work, and with respect to its interaction with other pension funding rules—is necessary before the yield curve can be definitively judged.

ASPA would be pleased to provide further input and/or to answer any questions lawmakers may have as they grapple with this important and complex issue. ASPA also thanks the Committees for this opportunity to provide our views.

Statement of Representative John A. Boehner, a Representative in Congress from the State of Ohio

I'd like to thank the witnesses for coming to testify on this very important subject. Strengthening the pension security of American workers is a top priority for this Congress, and today's hearing is the second in a series held by the Education & the Workforce Committee that examines the health of defined benefit pension plans, the type that promise to pay a specific monthly benefit to workers when they retire.

Thirty-year Treasury interest rates and pension funding calculations are all obscure and arcane topics to working families, but our goal here couldn't be more simple: To strengthen the retirement security of American workers by protecting the retirement savings that workers expect from their defined benefit pension plans.

The financial health of defined benefit plans is a critical issue for millions of workers, and the funding of these plans has become more challenging for many companies because of low interest rates, a sluggish economy, stock market losses, and an increasing number of retirees.

As a result, the number of employers offering defined benefit pension plans has declined from 112,000 in 1985 to just more than 30,000 last year. Some employers have even frozen or terminated their pension plans altogether.

The lack of a suitable, long-term replacement to the 30-year Treasury interest rate could jeopardize employers' willingness to continue their commitment to defined benefit pension programs. Solving this problem not only means providing greater certainty and relief to beleaguered employers, but more importantly strengthening the retirement security of millions of working families who rely on the safe and secure benefits that defined benefit pension plans provide.

While I am pleased that the Bush Administration has come forth with a proposal, we must consider its potential ramifications on employers, workers, and their families. That is the reason we are here today. We have an obligation to help ensure that the pension benefits promised to working families will be there when they retire.

I'd like to thank the Ways & Means Committee, and specifically Chairmen Thomas and McCrery, for their work on this issue. I look forward to working with them and the rest of my colleagues as we move ahead.

International Union, United Automobile, Aerospace & Agricultural Implement Workers of America
Washington, DC 20036
July 10, 2003

Honorable John A. Boehner
Chairman, House Education and the Workforce Committee
2181 Rayburn House Office Bldg.
Washington, D.C. 20515

Honorable George Miller
Ranking Member, House Education and the Workforce Committee
2101 Rayburn House Office Bldg.
Washington, D.C. 20515

Honorable Bill Thomas
Chairman, Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Honorable Charles Rangel
Ranking Member, Committee on Ways and Means
1106 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Chairman Thomas and Ranking Member Rangel:

The Treasury Department recently released its long awaited proposal for replacing the 30-year treasury rate for purposes of calculating pension plan liabilities. Unfortunately, this proposal would have serious negative consequences for workers, retirees and employers, as well as the continuation of defined benefit pension plans. Accordingly, the UAW strongly urges you to reject this misguided proposal.

The Treasury proposal would peg the new interest rate assumption for calculating pension liabilities for two years to a blend of corporate bond rates. However, following that brief transition period, the proposal would quickly phase in a yield curve under which the interest rate assumption would vary based on the age of the plan participants and the number of retirees. The UAW is very troubled by this yield curve proposal for a number of reasons.

First, the yield curve proposal is enormously complex, and would greatly increase the administrative burdens on plan sponsors. Instead of having a clearly defined interest rate assumption that would be known in advance, plan sponsors would be forced to utilize an assumption that could vary from year to year, depending on the precise age and retirement status of the plan participants. The volatility and lack of certainty inherent in this approach would negatively impact plan sponsors, and would inevitably discourage them from continuing defined benefit plans.

Second, the yield curve proposal would not lead to more "accuracy" in pension funding. Indeed, it ignores other factors that have a major impact on the timing of pension obligations, such as the mortality of the plan participants. It is noteworthy, in this regard, that the Treasury Department proposal fails to incorporate the recommendation made by the American Academy of Actuaries that plan sponsors be allowed to adjust their mortality assumptions to reflect differences between blue and white collar plan participants.

Third, and most importantly, the yield curve proposal would severely penalize older manufacturing companies that have larger numbers of older workers and retirees. As a result, it could force these companies to cut back pension benefits for their workers and retirees, or even to terminate their pension plans. It could also lead to sharp cut backs in retiree health care and other critically important benefits. And there is also a substantial danger it could result in more layoffs and plant closings. Thus, the yield curve proposal would be bad for workers and retirees in the manufacturing sector, as well as their employers.

The manufacturing sector has been extremely hard hit by the recent economic downturn, having already lost more than 2 million jobs. The UAW submits it makes absolutely no sense to penalize companies in this sector, by imposing enormously burdensome pension requirements on them. This will not lead to better funding of their pension plans. Instead, it simply will hurt workers and retirees by forcing benefit cut backs, plan terminations, layoffs and plant closings.

Instead of this misguided yield curve proposal, the UAW urges Congress to adopt a straightforward proposal that permanently replaces the 30 year treasury rate with a new interest rate assumption based on a high-quality corporate bond index or composite of indexes, with the highest permissible rate of interest being 100 percent of the four year weighted average of that rate. This approach has support in both the employer and labor communities, as well as bipartisan support in Congress. It is administratively simple, and will provide plan sponsors with the certainty and stability that is so important. In addition, it would approximate the rate for purchasing annuities, which we believe is the appropriate benchmark for protecting the security of pension benefits for workers and retirees and assuring that pension plans are adequately funded. Finally, it would treat all plan sponsors the same, and would not penalize older manufacturing companies.

The UAW believes it is extremely important that Congress act promptly to provide an appropriate replacement for the 30 year treasury rate for purposes of calculating pension liabilities. We urge you to reject the Treasury Department's yield curve proposal, and instead to adopt the straightforward corporate bond proposal described above. Thank you for considering our views on this critically important issue.

Sincerely,

Alan Reuther
Legislative Director

March of Dimes
Washington, DC 20036
July 14, 2003

The Honorable Robert E. Andrews
Ranking Member, Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives
Washington, DC 20515

Dear Representative Andrews:

On behalf of 1,500 staff and over 3 million volunteers nationwide, I am writing to thank you for holding a joint hearing on pension security and defined benefit plans. The Foundation urges you to act quickly to provide relief to defined benefit plans and to protect the pensions of current and future plan participants.

The March of Dimes is a nonprofit organization working to improve the health of mothers, infants and children by preventing birth defects and infant mortality through research, community services, education, and advocacy. The March of Dimes sponsors a defined benefit pension plan for its employees, which serves as an important tool for attracting and retaining high-caliber employees who are committed to the mission of the March of Dimes.

Like many other employers, the March of Dimes is concerned about funding pressures that are straining the stability of the nation's defined benefit pension system. One of the primary sources of this funding pressure is tied to the required use of an obsolete interest rate—the 30-year Treasury bond rate—as the benchmark for a variety of pension calculations, including those involving pension liabilities, pension insurance premiums, and lump-sum distribution calculations. Fortunately, there are positive steps that Congress can take to address these funding pressures and enable employers, including the March of Dimes, to provide financially sound pension programs. First and foremost, there is an urgent need to enact a permanent and comprehensive replacement for the 30-year Treasury bond rate, which can be achieved by promptly enacting the provision included in the Pension Preservation and Savings Expansion Act (H.R. 1776), recently introduced by Representatives Portman and Cardin. Their proposal offers a balanced and carefully structured solution to a complicated and urgent pension funding problem.

If retirement plans such as the March of Dimes defined benefit plan are to remain viable as a long-range planning tool providing retirement income security for current and future employees, Congress must take quick action to relieve the very real funding pressures now faced by these plans. Thank you for your ongoing efforts on behalf of the employees of the March of Dimes and other tax-exempt organizations. Please call on us if we can be helpful in moving this bill to enactment this year.

Sincerely,

Marina L. Weiss, Ph.D.
Senior Vice President Public Policy & Government Affairs

United Airlines Master Executive Council of the Air Line Pilots
Association, International
Rosemont, Illinois 60018
July 15, 2003

U.S. House of Representatives
Committee on Ways and Means
Washington, DC 20515

My name is Captain Paul Whiteford, Chairman of the United Airlines Master Executive Council of the Air Line Pilots Association, International. In this capacity, I represent more than 13,000 active, furloughed and retired pilots at United. I have been a pilot with United for 25 years and was proud to serve our country as a pilot in the US Air Force from 1973–1974 during the Vietnam conflict. I also am proud to represent the pilots at United, one of the hardest working and most professional groups of men and women in the airline industry today. United workers have suffered enormous hardships in the past few years, punctuated by the loss of two of our aircraft and our crew and passengers in the September 11th terrorist attacks.

In addition to enduring the emotional turmoil of September 11th, our pilots have agreed to a base wage reduction of 30% and when you take into consideration that the majority of our pilots have been demoted to lesser paying jobs in the system, the fact is that many of us have seen our take home wages reduced by more than 40%. We have seen our benefits reduced, been forced to relocate, taken furloughs—all with the goal of sustaining the airline and delivering a safe and secure vital service to our fellow citizens.

Speaking on behalf of these men and women, it is an honor to submit testimony to this joint hearing of the Select Revenue Measures Subcommittee of the Committee on Ways and Means and the Employer-Employee Subcommittee of the Committee on Education and the Workforce. Exploring and finding a solution to the pension-funding crisis facing the airline industry today is a critical priority for our membership.

I want to first commend the Bush Administration and the Department of Treasury on its current proposal to extend existing pension funding relief provisions, set to expire this year, for two more years. This provision lets under funded plans use the corporate bond rate as a replacement for the 30-year Treasury bonds for a variety of defined benefit pension calculations. It is our belief that this proposal will go a long way toward solving some of the more immediate pension funding issues in the airline industry, including the situation at my employer, United Airlines, which has been operating under the protection of the bankruptcy court since late 2002. We think addressing this issue is the right strategy and certainly the right first step. However, we also believe this proposal alone will not fix America's troubling pension problem.

We believe pension reform must be expanded beyond this initial step. I want to offer my voice, the voice of 13,000 pilots at United, all of whom are joining the voices of our fellow 66,000 pilot members of the Air Line Pilots Association in asking Congress to go further and enact legislation that would provide air carriers with a temporary exemption from certain pension funding rules. Without this help, we are very concerned about the survival of the industry. This industry has been devastated by the events of September 11th, the global recession, the spike in oil prices, the Iraq war and the SARs virus . . . all issues beyond our control.

I am pleased to say that on this issue, our union stands alongside United's management in our shared commitment to solve the pension funding issue. In my experience, labor and management do not always share points of view on pension reform or other negotiated matters. I would hope the Members present at today's joint hearing would appreciate the common platform and bond that my members share with the leadership at United and the other major carriers on this issue.

Before we get to the specifics of the legislative solution we propose, let me take a moment to paint a quick backdrop on the airline industry and the history of pension funding.

Each of the major airlines has sponsored defined benefit pension plans. These are for pilots, other unionized employees and management. At the end of 1999, airline industry defined pension plans held about $33 billion in assets to support about $32 billion in projected benefits obligations. The plans were, on average, approximately 102% funded. At the end of 2002, the major airlines had pension assets of about $26 billion to support projected benefits obligations of approximately $49 billion, creating a funding level equal to less than 54%. This steep, short-term decline in funding levels is remarkable in its scope and is attributable to two central factors: three years of declining equity markets and the fact that market interest rates, used to discount pension liabilities, are at 40-year lows.

During this period, the industry suffered from a serious and critical economic tailspin. Losses for the last two years are more than $20 billion and the industry is expected to lose another $8 to $13 billion in 2003. United Airlines is in bankruptcy. US Airways recently emerged from bankruptcy. American Airlines is attempting to restructure outside of bankruptcy. Other carriers are facing significant economic pressure and may be forced into the bankruptcy arena.

We fervently believe the major airlines need additional legislative relief at this critical time. Such relief would allow the industry to marshal its liquid assets to weather the current economic crisis, to remain out of bankruptcy (or in the case of United, emerge successfully from bankruptcy) and to retain a viable domestic airline industry. We expect that interest rates will return to historic norms and note that the equity markets are already showing signs of rebound, which should help restore more traditional rates of return. Because pension plans are long-term propositions, funding relief is appropriate to give time for these abnormal market factors to correct and for the airlines and their unions to explore other means of reducing under funded pension plans.

Before I outline our proposal, I want to let the Members present know that we have been very focused on what we can do to reduce United's pension funding commitments. In fact, during what was a series of very difficult negotiations in the Spring of 2003, we agreed to several significant changes in our pension structure. The defined benefit plan requires a monthly retirement payment to a pilot, which is the product of three factors: the pilot's years of service, a multiplier and his final average earnings. All three components have been changed in a way which reduces the pilot's pension and, therefore, the Company's pension obligations. Years of service, which previously were unlimited, are now capped at 30. The multiplier has been reduced from 1.5 to 1.35. And the final average earnings over time will reduce as a direct function of the lowering of the wages. Moreover, the pilots have agreed to reduce the Company's annual contribution to a companion defined contribution plan. These concessions substantially reduced our pension benefits by 35%, which equates to approximately $1.5 billion in pension funding reductions through 2008 alone.

The proposal we support is very straightforward. It is designed to provide airlines with a temporary five-year moratorium from deficit reduction contributions for any plan with a funding percentage of less than 80%. Airlines still would be required to contribute at least the minimum funding contribution compelled under current statute, but would be exempted from the more onerous funding requirements included in current law. In addition, we are proposing that airlines be permitted to amortize existing minimum funding requirements over a new 15-year period, as opposed to the current five-year period. The proposal also clearly states that once the funding percentage for any pension plan is at least 90% for any plan year during this moratorium, the moratorium ends and the airline will be required to return to previous funding and amortization requirements.

The significance of this proposal is worth reviewing. By affording the airlines an opportunity to conserve cash during this extreme cyclical trough, Congress will be ensuring the survival of the airlines, the continued employment of hundreds of thousands of airline workers, and protect the previously earned benefits of those already retired. It would avoid the devastating act of terminating defined benefit plans, many of which are under funded due to macro-economic shifts beyond the control of the airline or the unions. It is the right thing to do at the right time.

In closing, I again applaud the Bush Administration and these two Subcommittees' efforts to find a solution that will solve today's pension funding crisis. We hope you will give serious consideration to our proposal on its merits and its intent. Thank you for this opportunity to present our perspective.

Sincerely,

Captain Paul Whiteford
Chairman of the United Airlines Master Executive Council
Air Line Pilots Association, International

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