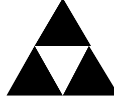

AMERICAN ACADEMY *of* ACTUARIES

U. S. Senate Committee on Governmental Affairs

Subcommittee on Financial Management, the Budget, and International Security

Hearing:

Safeguarding America's Retirement Security: An Examination of Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation

Testimony Presented by:

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

Introduction

Chairman Fitzgerald, Ranking Member Akaka, and distinguished committee members, thank you for inviting me to testify on the "Defined Benefit Plan Funding Crisis." My name is John Parks, and I am the Vice President for Pensions and Chairperson of the Pension Practice Council of the American Academy of Actuaries. My testimony today is a reflection of input from numerous members of the Academy's pension committees and other actuaries.

The Academy's Pension Practice Council and its committees are made up of senior actuaries who work for large and small consulting firms, insurance companies, unions and corporations and provide professional advice representing all types of retirement programs from our nation's largest plans to single entrepreneur arrangements, from not-for-profit organizations to corporations and multiemployer funds. Our council members are committed to providing objective information and analysis to ensure the viability of our national voluntary retirement system and to support the position that defined benefit (DB) retirement programs provide a vital form of retirement security for the American people.

Background and Challenge

The challenge of retirement economics is not faced by our nation alone but in many aspects is shared globally. The combined impact of increased life expectancy and reduced fertility rates has commanded that all nations look for solutions that are reasonable and can be relied upon by current and future retirees. Declines in the equity market and reduced interest rates are currently creating an even greater challenge to cohesive and effective retirement systems. While many of the issues are global in nature, this testimony will deal with the specifics as they relate to our nation.

In addition to the recent (and hopefully temporary) funding crisis we must also remember that for at least 10 years, perhaps 20, there has been a steady shift away from guaranteed retirement income and toward self-annuitization. The danger in this transfer of financial risk to individuals is largely unseen because the people affected have mostly not yet retired. We must deal, therefore, not only with current (and perhaps temporary) financial conditions but also with the long-range challenges facing DB plans in general.

"Pensions 101" taught us many years ago that an excellent voluntary employer supported retirement program (supplementing an effective Social Security system) is the combination of defined benefit and defined contribution (DC) plans. The defined benefit plan provides a base monthly retirement income guaranteed for life and the defined contribution plan – typically a 401(k) - allows both the employer and the plan participant to supplement that income. The defined contribution plan could and has under the right market conditions allowed for significant wealth generation. The foundation, however, remains the defined benefit pension plan. It is a critical part of this retirement economics challenge to see that defined benefit plans are supported and plan sponsors are provided with the incentive to maintain and cultivate these programs. Some special advantages of DB plans include:

- For employees, DB plans provide a secure, stable income for life. Employees won't have to worry about risks, such as a bear market when they want to retire or after they retire, or outliving their money. DB plans are an effective device for spreading mortality risk for the retirees and can only be achieved through such a plan of formal annuitization.

- For employers, DB plans can provide contribution flexibility and are better at keeping a stable workforce. They are also usually professionally managed and, therefore, achieve similar or higher returns with less risk than a typical employee-directed account (per Table E24 of the 1998 DOL Form 5500 abstract).

- For the nation, DB plans help reduce our dependence on social programs, such as Medicare, Medicaid, and Supplemental Security Income (SSI) and they reduce poverty among the elderly more effectively than defined contribution plans.[1]

In 1975, just after the Employee Retirement Income Security Act (ERISA) was signed into law, 40 percent of the labor force participated in a DB plan, and 16 percent participated in a DC plan (see chart, *Participation Rates in Pension Plans*, at end of testimony). Today, however, the reverse is true: only 21 percent participate in a DB plan, while 46 percent participate in a DC plan.[2]

The challenge is finding an effective balance between the universal goal of providing secure retirement income and the often-conflicting needs of protecting the participant, finding reasonable funding and accounting solutions for the sponsoring employer and managing the risk to the Pension Benefit Guaranty Corporation (PBGC). These written comments will explore the following related and important issues for this hearing.

- Funding (the systematic accumulation of funds to meet current and future obligations to plan participants)
  - Simplification of the rules
  - Maximum tax-deductible contributions
  - Addressing withdrawals

- Solvency (the ability of a plan to meet its obligation to participants in the event of a catastrophic corporate event such as corporate reorganization or bankruptcy)
  - PBGC concerns
  - Fixing the discount rate

- Accounting (the appropriate representation of the net obligation, particularly for public companies, to allow for the accurate assessment of the organization's ability to meet this obligation along with its other business financial needs)

The frameworks for two of these three factors, solvency and funding, are defined by federal laws and regulations, while the accounting framework is defined for the most part by the Financial Accounting Standards Board (FASB). Each factor needs to be addressed, considering the applications for the primary audience, but we must also consider the ramifications for plan sponsors and participants if we want to develop effective retirement policy for the country.

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[1] Additional advantages can be found at http://www.actuary.org/pdf/pension/testimony_20june02.pdf

[2] The 2000 Form 5500 data are not available yet, because pension plans file about nine months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

Funding – Simplifying the Rules

Years of almost annual amendments to ERISA have continually increased the administrative burden on those who try to maintain defined benefit programs, putting many employers at a disadvantage. Those companies who sponsor DB plans are now questioning the future of their programs under the current financial strains of the economy; mandated, overly rigid and short range funding requirements; accounting difficulties; arcane pension laws and regulations; and the uncertainty they face with this type of plan.

There are many different aspects of today's economic environment that threaten the voluntary DB system. The decline in equity markets and interest rates has (at least temporarily) simultaneously caused the assets supporting pension funds to decline and the funds' liabilities to increase. These two forces have dramatically shifted the funded status of most, if not all, DB plans. Funding requirements have not only increased to compensate for lower investment returns over the past three years, but the simultaneous decline in 30-year Treasury rates has triggered additional funding under the deficit reduction contribution (DRC) requirement of Internal Revenue Code (IRC) Section 412(l).

The stakeholders for funding are the taxpayers, participants, and plan sponsors. Funding and tax deductible contributions translate to federal revenue cost and are also a reflection of deferred compensation for employees.

Simplification is necessary to reduce the regulatory cost of DB plans, level the playing field for defined benefit plans and defined contribution programs, and provide a viable system with stable rules to attract new plan adoption – all of which are needed to meet the financial security of retiring Americans. For example, there are 11 different amortization periods/rules (including the separate rules for multiemployer plans) for paying off liabilities in the funding rules in IRC Section 412(b) [Funding Standard Account] and two more in Section 412(l) [Additional Funding Requirements]. The accounting standards only have three rules (working lifetime, retiree lifetime, and period benefits for frequent amendments). In addition, the IRC rules create disconnects between the payment of benefits and the funding of benefits. They allow employers to improve retiree benefits (which are payable over 10 to 20 years) and pay for the improvement over 30 years, which can hurt a pension plan's funding levels. On the other hand, underfunded plans must pay off their deficit in three to seven years under IRC Section 412(l), so the amount of required contributions can be very volatile when plans are forced to go from 30-year funding rules to 7-year funding rules. In fact, the volatility is even more dramatic for plans that were prohibited from making deductible contributions in the late 1990s, and now must fund their deficits over seven years (see the attached chart labeled *Current Contribution Rules*).

This problem did not happen when the rules were implemented. In the 1980s, current interest rates were significantly higher, so the current liability (CL) was much lower than the actuarial liability in the full funding limit, and the funding rules allowed plans to create surplus margins in their plans. Today, however, the full funding limit (FFL) can be less than the unfunded current liability for some plans (e.g., hourly plans which cannot project benefits). This makes it difficult for those plan sponsors to create a surplus to get through difficult times. Employers may not have wanted to increase surpluses in the past due to the high reversion tax, but recent experience has taught them the value of having a surplus in their plan.

Specific suggestions:

- **Allow faster Amortization**: The funding rules could be simplified, strengthened, and made less volatile with one change – reduce the number of amortization periods. The funding rules found in the funding standard account (Section 412(b)) could use something less than the 20- and 30-year periods, but more than the 5-year period for experience gains and losses (which causes volatility). Accounting rules already require a shorter period for expensing, so sponsors may be ready for this change. Unfunded retiree liabilities and frequent benefit improvements could be amortized faster if desired, which would be a simpler and better way to handle mature plans than using a yield curve. This rule would also be closer to the rules for underfunded plans, but some additional smoothing may be needed to phase into them. Faster amortization would also address the concerns that PBGC has with large credit balances eliminating deficit reduction contribution.

- **Rewrite Funding "Standards":** ERISA introduced **minimum** funding standards intended to ensure solvency to pay benefits. Over time these became de facto fiduciary standards of behavior when greater contributions were obviously necessary. This unintended result flows from the idea of legal compliance as a safe harbor for judging fiduciary responsibility. While not a change that should be adopted lightly, perhaps the detail of annual funding should be left to the plan sponsors with the government's role focusing on plan solvency. Because such a change would require time for study and debate the amortization changes would still be required as an interim measure.

Funding – Changing the Tax-Deductible Contribution Maximum

Our pension funding rules create volatile contribution patterns and discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong – and require substantial contributions when the economy declines and plan sponsors can least afford them. As news reports have noted, a number of companies in a wide variety of industries now find that their survival is threatened by the cash contribution requirements of pension plans that were reasonably well funded just a few years ago.

In the 1990s, a number of companies might have contributed to their well-funded pension plans, but could not because a contribution

1. would not have been deductible,
2. would have resulted in an excise tax, and
3. would have created an inaccessible surplus that could not be used for other purposes if it was unneeded by the plan.

Not only were employers restricted from making contributions in past years but also, unfortunately, many became accustomed to the contribution holidays. Now, they have to contribute unusually large amounts to their newly underfunded pension plans. As I mentioned earlier, declines in the stock market and unusually low interest rates left many plans underfunded and triggered the deficit reduction contribution rule. (The chart, *Allow Contributions in Good Years,* at the end of this paper shows this graphically.) This dramatic economic change has made it difficult for many companies to come up with the necessary funds. Some firms responded by deciding to freeze and/or terminate their defined benefit

plans. Others find themselves in bankruptcy, unable to support their pension plans and looking to the PBGC for benefit guarantees.

Expanding current contribution limits would reduce this volatility. Ironically, a number of plan sponsors who would have liked to shore up their pension funding (and thus their balance sheets) by contributing their unfunded accumulated benefit obligation (ABO) at the end of 2001 and 2002 were unable to do so. If employers had been allowed to make deductible contributions, some would have done so in order to avoid the difficulties they are experiencing today, and pension plans (as well as the PBGC) would have been in better shape financially. Going forward, employers are now much more keenly aware of the risk of declining funding levels, and many would be interested in taking advantage of changes in the law that would allow them to build larger funding "cushions" against this risk.

Suggested remedies:

Increase the tax-deductible contribution maximum

Contributions are not deductible, and are subject to a 10 percent excise tax, when plan assets exceed currently defined maximum tax-deductible limits. Congress has addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability – but even this has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When interest rates were higher, the full funding limit provided a more generous margin above currernt liability, at least for pay-related plans, which have the ability to project future compensation increases when calculating the limit. However, when current interest rates are low,[3] the deductible limit provides little or no margin for adverse fluctuations in assets or liabilities – and, in many cases, as discussed later in this paper, does not even include liabilities for benefits the plan is committed to provide. Over the past three years, we have seen a large decline in the funded status of plans – both because the market value of plan investments has fallen, and because liabilities have increased due to lower discount rates. The significance of this decline depends on whether the changes are transitory or permanent.

Thus, we suggest policymakers consider allowing sponsors to deduct contributions until the plan is funded to some higher amount such as 130 percent of current liability (without smoothing of interest rates or asset values).[4] This 30 percent margin would have covered all but two periods in the last 100 years: the depression years (dramatic decreases in stock prices) and the past two years (dramatic decreases in stock prices and decreases in interest rates). If policymakers want the margin to cover a period that resembles the past two years, then approximately 165 percent or more might be needed.[5] If

[3] For hourly plans (and plans with a large proportion of retirees), the full funding limit will generally be less than termination liability (TL) (because they cannot project benefit improvements), so they have no margin for adverse fluctuations. These are the very plans that are more likely to be underfunded now.

[4] This can be accomplished by replacing the words "current liability" with the words "130 percent of current liability" in §§404(a)(1)(D) and 404(a)(7)(A), and defining it using the current interest rates, not smoothed ones.

[5] What should this margin be? A frozen plan funded to 100 percent of TL, would be only 65 percent funded if stocks fell 50 percent (as they did over the 2-year period from the mid-2000 to mid-2002). We assumed the plan has the typical 70 percent of assets in stocks. If in addition, interest rates were to decrease by 1 percent (as they did during the same time period), then the funding ratio would be only 61 percent. This calculation assumes that 35 percent of plan assets in bonds have the same duration as the plan liabilities. If they are of shorter duration, then the funding ratio would be lower than 61 percent. A plan

the plan had shutdown benefits, an additional margin could be added equal to the present value of additional benefits as if shutdown benefits were triggered on the valuation date.

However, we recognize the need to balance concerns about pension security with concerns about the revenue impact; to address this perhaps a percentage lower than 165 percent could be used or the use of a larger margin could be restricted (to plans covered under Title IV of ERISA, for example). Other ways to improve funding are described in the following sections. In addition, we note that revenue losses may not be as great as might appear, since if a plan sponsor takes advantage of this provision now, smaller contributions would be possible in future years.

It is also important to recognize that the tax impact of DB plans is to defer, not exempt, funds from taxation. Amounts not taxable in a current year are taxable to a plan sponsor or plan participant in the future.

Allow deduction to reflect increases in unfunded liability at year-end

Many companies contributed (or would have liked to contribute) an amount to fully fund their liabilities at year-end, in order to improve the plan's funded position and possibly improve their corporate balance sheet. This contribution helps participants and the PBGC, and makes the pension plan 100 percent funded (on this basis), which should be encouraged. However, such a contribution may not be deductible under existing regulations. The unfunded liability at year-end can be larger than the unfunded CL used to determine the maximum tax-deductible contribution, because the latter does not include several items that can increase the unfunded liability during the year:

(1) Any asset losses that occur during the year
(2) Adverse changes in the interest rate used to calculate current liability
(3) Benefit improvements that are not included in the current valuation because they are adopted or become effective after the valuation date.
(4) Any increase in liability due to the government-required subsidy in lump sums or to future increases expected in federal benefit and compensation limits, which CL is prohibited from including.

We suggest that, as an alternative, employers be permitted to recalculate the maximum tax-deductible contributions for a year based on estimated year-end unfunded current liability. This could be done using actual year-end market values and current liability adjusted to reflect the approximate effects of changes in the current liability interest rate and other changes -- perhaps using the same principles as currently applied to adjust liabilities for PBGC variable rate premiums to reflect "significant events."

Allow deduction up to the amount that will eliminate the PBGC variable rate premium

Similarly, employers may wish to fund the amount necessary to eliminate the PBGC variable rate premium for the following year.

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funded to 130 percent of TL, would similarly become only 79 percent funded. A plan funded to 165 percent of TL would become 100 percent funded.

One way to exempt a plan from the variable rate premium is to fund an amount up to the full-funding limit for the prior year. If the plan's full-funding limit is based on the Retirement Protection Act of 1994 (RPA'94) override, the sponsor can deduct the necessary amount under current rules — a contribution up to 100 percent of current liability is deductible, and the RPA'94 full-funding limit is based on only 90 percent of current liability. However, if the Omnibus Reconciliation Act of 1987 (OBRA '87) limit or the actuarial accrued liability under the plan's funding method drives the plan's full-funding limit, current rules may not permit the deduction of the amount necessary to eliminate the variable rate premium.

We believe the additional security of a better-funded plan is more valuable than the additional premium dollars for the employer, the participants, and the PBGC.

Eliminate 25 percent restriction on combined defined contribution/defined benefit deductions

Current law restricts the deductible contribution for defined contribution plans if the combined contribution for defined benefit and defined contribution plans exceeds 25 percent of covered payroll. This is yet another impediment for employers who would like to strengthen the funding of their defined benefit plans, although Congress has partially addressed this by at least limiting the situations in which the 10 percent excise tax applies. If the 25 percent restriction could be eliminated with respect to tax deductions or at least with respect to the 10 percent excise tax, employers could contribute additional amounts to the defined benefit plan without jeopardizing contributions for defined contribution plans.

Allow all negotiated benefits to be reflected for bargained plans

It is generally believed that bargained plans are not as well funded as other plans. The reasons for this are arguable, but one is the effect of federal rules for both minimum and maximum funding purposes which do not permit future benefit improvements (even those that have already been negotiated) to be recognized in the calculations. This gives national sanction to ignoring unearned, yet probable, benefit liabilities in current funding decisions. By comparison, federal rules for salary based benefits require the use of a salary increase assumption in the funding calculations to project future benefit increases, although these projected benefits are not yet accrued (or earned) as of the current calculation date. The negotiated benefit improvements are reflected in the basic ERISA liabilities for the plan – but the corresponding increase in liability is amortized over the next 30 years. New improvements are likely at the end of the current labor agreement in three to five years. Thus, these plans are always behind in funding.

One partial approach would be to allow current liability to include the cost of benefit improvements already negotiated but scheduled to take effect in the future. This would allow the plan sponsor to reflect the cost of the full commitment to employees in their contribution levels, so that they could secure these benefits without continually falling behind as new levels of benefits are negotiated.

Multiemployer Plans

Proposals to allow deductions up to 130 percent of accrued liabilities would also be very important for multiemployer plans because their contributions are generally fixed for the length of the bargaining period. If asset returns are unusually good (like in the 1990s), the assets could easily exceed the full

funding limit for these plans (which, as discussed earlier, cannot include future amendments increasing benefits). This will cause the fixed contributions to not be deductible (and subject them to an excise tax). To alleviate this problem, multiemployer plans increased benefits (sometimes to surprisingly high amounts) in order to make the contributions deductible. With the recent fall in asset values, they now have the opposite problem. The fixed contribution is now less than the minimum required contribution, which will subject them to a 5 percent excise tax, and eventually a 100 percent excise tax. However, since accrued benefits cannot be cut, it can be difficult – if not impossible – to fix this problem. The best solution is not to induce companies to handicap themselves with unneeded benefit increases when assets do well. Allowing deductions up to 130 percent of current liability in IRC 404(a)(1)(D) (or allowing the projection of future benefit increases) for multiemployer plans could generally resolve this concern.

Reflect lump sum payments in current liability

Plans that offer voluntary lump sum payments must provide them using the subsidized interest rates required under IRC Section 417(e). These interest rates can dramatically increase the liability associated with these pension benefits, and employers cannot avoid this liability (at least for already-accrued benefits) by amending lump sum benefits out of the plan without violating anti-cutback rules.

However, even though they are committed to providing these benefits once they are in the plan, employers are not permitted to reflect the additional cost in current liability. This restricts their ability to contribute amounts needed to support the plan. We recommend inclusion of the full lump sum amount, at the very least for maximum deductible purposes, and preferably for all purposes.

Allow deduction for normal cost in all years

It might be helpful if employers could make a deductible contribution to the pension plan every year. That would avoid the recent problem of some employers no longer budgeting for contributions to their pension plan (because they were not deductible). What should this contribution be? Some actuaries have suggested that the aggregate method normal cost[6] (or open group normal cost) be deductible in all years. They note that one reason assets exceed actuarial liabilities at certain points in time is because asset returns have been better than expected. If assumptions are correct on average, then asset returns could be lower than expected at some point in the future. Given this dispersion of asset returns, the normal cost using an average interest rate may be appropriate every year. If necessary, a cap could be imposed on funding – e.g., the rules could specify that no contribution is deductible to the extent it results in assets greater than the total present value of benefits.

Graduate the normal cost

An alternative to the above suggestion would be to phase out the deductible contribution gradually, instead of eliminating it all at once. For example, a plan sponsor could deduct the normal cost minus the surplus divided by five. Thus, when the surplus is zero, the normal cost is deductible. When the surplus is five times the normal cost, it would be zero. This deduction rule would phase out between those two surplus amounts.

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[6] Plan sponsors could be permitted to use the aggregate or open group method for their maximum contribution in any year, without getting approval from the IRS.

If this general approach is acceptable, policymakers in the U.S. could adjust the actual mechanics, if desired. For example, the threshold for determining surplus could be 130 percent of current liability (or the FFL if greater) and/or the phase-out period could be extended to 10 years.

Allow or Mandate?

Some policymakers may suggest that underfunded plans should be required to contribute more. To minimize controversy over enactment we suggest the changes to the rules for *allowable* deductions but not the contribution *requirements.*

There are now strong incentives for companies to contribute more. For example, if assets fall below the accumulated benefit obligation, there can be adverse implications for the employer's corporate balance sheet. If assets fall below the liability for vested benefits, companies must pay an additional premium to the PBGC. If assets fall below 90 percent of current liability, contributions can increase dramatically. Recent drops in the market have provided a good reason for employers to increase their funding margins and build a "cushion" to protect against adverse experience.

A list of the underfunding penalties follows. If policymakers want to increase the incentives for funding, then a threshold for any one or more of the penalties could be increased (e.g., the threshold for security).

If the funding ratio falls below*	Then
125 %	No §420 transfer to the company post-retirement health plan Company cannot use the prior year valuation
110 %	Restrictions on the size of lump sums to the top 25
100 %	Accounting rules may force a hit to net worth PBGC variable premiums are payable Companies must pay quarterly contributions PBGC files lien on company if missed contributions > $1 M PBGC financial filings required if underfunded over $ 50 M Must report certain corporate transactions to PBGC if underfunded Bankrupt firms cannot increase benefits
90 %	Additional deficit reduction contributions required Notice to employees with funding ratio & PBGC guarantees required
60 %	Security required for plan amendments

*Note that the above ratios are based on varying measures of liability

Funding – Addressing Withdrawals

Incentives for employers to increase their funding margins may not work unless we also address the one-sided nature of the funding equation – employers who try to protect the plan by making additional contributions have very little opportunity to use those contributions if it later turns out that they weren't needed. For example, if an employer contributes enough to increase a plan's funding ratio to 130

percent, and then the stock market does very well, the plan may become so overfunded that the pension plan will never need all the assets.

If the employer needs some of the surplus pension money, it has few options other than terminating the pension plan. Not only is this a difficult, complex process that disturbs employees, but 85 percent of the margin would have to go to the federal government and even more would be paid in the form of state and local taxes, leaving very little for the plan sponsor who funded the plan.

One suggestion would be to only allow the reversion if:

- Assets exceed some high threshold (e.g., 150 percent of current liability, or the FFL limit if greater), and
- The uses of the reversion could be restricted to employee benefit plans.

If the above two requirements are met, the withdrawal could be subject not to the excise tax, but to the maximum corporate tax rate alone, regardless of current tax status, in order to make it a neutral element in the decision of whether to overfund.

In addition, the excise tax for reversions (and other withdrawals when assets exceed the above threshold) could be defined as that amount that eliminates the tax shelter on the withdrawal (based on some assumption as to how long the surplus was in the plan). This percentage should be much lower than the current 20 percent and 50 percent excise tax rates, due to the much lower tax rates on dividends just enacted this year.

Solvency - PBGC Concerns

We suggest that the provisions of the IRC Section 412(l) [Deficit Reduction Contributions], other laws and regulations, as well as the activities of the PBGC, can best be described as issues of plan solvency. The appropriate discount rate for IRC Section 412(l) is fundamental in assessing the adequacy of funding. Solvency has become a critical issue because of the decline in assets coupled with the decline in the discount rate, which is used to measure liabilities to determine funded status and potential requirement of deficit reduction contributions.

The PBGC and the plan participants are the primary stakeholders when it comes to plan solvency. They both focus on the plan sponsor's ability to meet the plan's obligations to the employees, especially in the case of plan termination. The need to find an appropriate discount rate replacement for the 30-year Treasury rate is specifically an issue of solvency, since the discount rate helps determine a plan's funding ratio and whether a deficit reduction contribution is required.

Due to the triple whammy of plummeting stock prices, lower interest rates, and the confluence of economic events that has raised the risk and number of bankruptcies, the PBGC balance sheet went from a surplus of $10 billion just two years ago to about a $5.7 billion deficit (unaudited for July 2003). However, the dollar amount of the deficit may not be as relevant as the funding ratio, which is 90 percent. Each time the PBGC takes over a pension plan, it also takes over the plan assets. PBGC's assets are now over $31.5 billion[7] while its annual outgo is expected to be around $3 billion. Thus, the PBGC

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[7] This $31.5 billion amount includes the $6 billion in assets from probable plans in PBGC's FY 2002 annual report (such as Bethlehem Steel), because PBGC includes such liabilities in the report.

likely will not have problems fulfilling its primary mission for a number of years — to pay guaranteed benefits on time. This is not to say that we do not need a change in the funding rules. On the contrary, the Academy has already met with the PBGC to discuss ways to fix them. We are just saying that PBGC's large asset base allows time to thoroughly examine various alternatives to fix the funding rules before enacting them.

This discussion so far has only taken into account PBGC's past terminations. However, PBGC's financial status is also intimately linked with how industries (like the airline industry) fare over the next several years. The pension underfunding at several weak airlines exceeds $10 billion. In fact, PBGC's 2002 Annual Report forecasts that future claims could be twice the average of past claims — a clear signal that the PBGC may want to increase premiums and/or tighten funding rules.

Solvency – Fixing the Discount Rate

There is an urgent need to fix the discount rate, which is currently based on 30-year Treasury rate. This is an important issue that needs urgent attention, as various groups are discussing a number of alternatives, and it appears that Congress may make a decision in the near future. This rate is used for the determination of cash contributions, variable rate PBGC premiums, and other key pension calculations. Current law defines this interest rate in terms of 30-year Treasury bonds; these rates have been artificially depressed, significantly raising the currently measured costs associated with pension plans.

The discontinuance of 30-year Treasury bonds caused the laws of supply and demand to increase their price, reducing the rate. In addition, when the Federal Reserve Board (FRB) dramatically reduced lending rates, it brought interest rates down to historic lows.[8] The 30-year Treasury rate was adopted as a benchmark to approximate the annuity purchase rate; today it falls well below the current trend. The chart of discount rates at the end of this testimony shows that the maximum permissible rate was less than an annuity pricing rate in 2000 and 2001, and the rate would have been lower in 2002, if it were not for the temporary fix that Congress passed last year.

Without an adequate permanent replacement rate, some employers are forced to use drastic measures when addressing the future uncertainty of the funding obligation. While I have seen no statistics on the number of plan sponsors who have already frozen their plans to future accruals, many pension actuaries have clients who have frozen their plans and others that will be forced to freeze accruals in the future if they cannot adequately project reasonable future funding obligations.

The current version of the *Pension Preservation and Savings Expansion Act of 2003* includes the recommended use of a high-quality, long-term corporate bond rate. This legislation has the support of employers and labor, and we find it to be a more realistic and reliable measure to benchmark the true cost of annuities in the market. The bill also retains the use of a rate within the permissible range. While we do not take a position on the specific endpoints, a range is also appropriate because it allows for contribution flexibility.

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[8] Some argue the FRB actions have little effect on long rates. This is why the current yield curve is steep; FRB has driven down short rates with lesser impact on long rates.

Some groups have proposed the introduction of a full yield curve, which would mean that each individual pension plan would be valued using a different interest rate. While the valuation software of most major actuarial firms can accommodate these calculations, this method would increase the complexity and cost of the annual pension valuation, with relatively little change in the results, even though the current yield curve is relatively steep. If the yield curve returns to historical patterns, the effect of adding this complexity would be even less noticeable.

Furthermore, if it is decided to introduce the apparent degree of precision that is inherent in using a yield curve for assumed interest rates, it seems appropriate to reflect differences in mortality rates as well. In many cases, moving away from the current "one-size-fits-all" requirement – in particular, introducing "blue"- versus "white"-collar mortality rates and generational mortality projections – could essentially negate the effect of incorporating the interest rate yield curve.

Another issue policymakers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount rate in accordance with Congress's earlier intentions (something close to a corporate bond rate or annuity pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans (hopefully while the economy recovers). This could mean that fewer plans will need to be trusteed by the PBGC, and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer-based retirement programs.

Recommendations

The replacement benchmark of high-grade, long-term corporate bonds is a reasonable proposal consistent with the intended measurement. However, while the various funding issues are studied, the period of temporary enactment should be five years rather than two or three years, as proposed by the Administration and others. A longer period will provide a higher degree of certainty for employers, allowing them to make longer-term commitments and to develop appropriate funding policies to fit their business plans.

The drafters of the OBRA '87, that provided for the measurement of funded status and mandated funding escalation, could not have anticipated today's environment. They could not have anticipated the Treasury's decision to stop issuing 30-year bonds, nor could the rules have been prudently developed to anticipate an investment market like the one we've experienced over the past three years. During that time, plan sponsors have faced the additional challenge of grappling with a complex set of rules that identify solvency concerns and require higher funding levels. The net result is an increase in funding volatility for companies, some of whom have funded their plans to the maximum allowable by law throughout the 1990s. The combined market conditions place many very well funded plans in a position of having to make dramatically increased contributions immediately or in the near future while attempting to responsibly determine the future viability of their plans.

We need a system that is straightforward and predictable. There could be three types of measures: one that reflects a decline in funded status due to economic changes such as declining interest rates and markets; another that reflects a decline due to business practice relating to the sponsor's degree of responsibility for meeting its obligation to fund plan benefits; and a third that reflects a measure of the

risk a plan is subject to because of provisions like lump sum options, subsidized early retirement, and shut down benefits. Using methods similar to those for evaluating gains and losses in assessing funding experience against assumptions, the source of funded status decline can be determined with different remedies provided, based on the cause. This approach, along with some facts and circumstance provisions for plans that experience extreme changes, would allow companies that can demonstrate their ability to meet long-range obligations the opportunity to apply more gradual contribution increases.

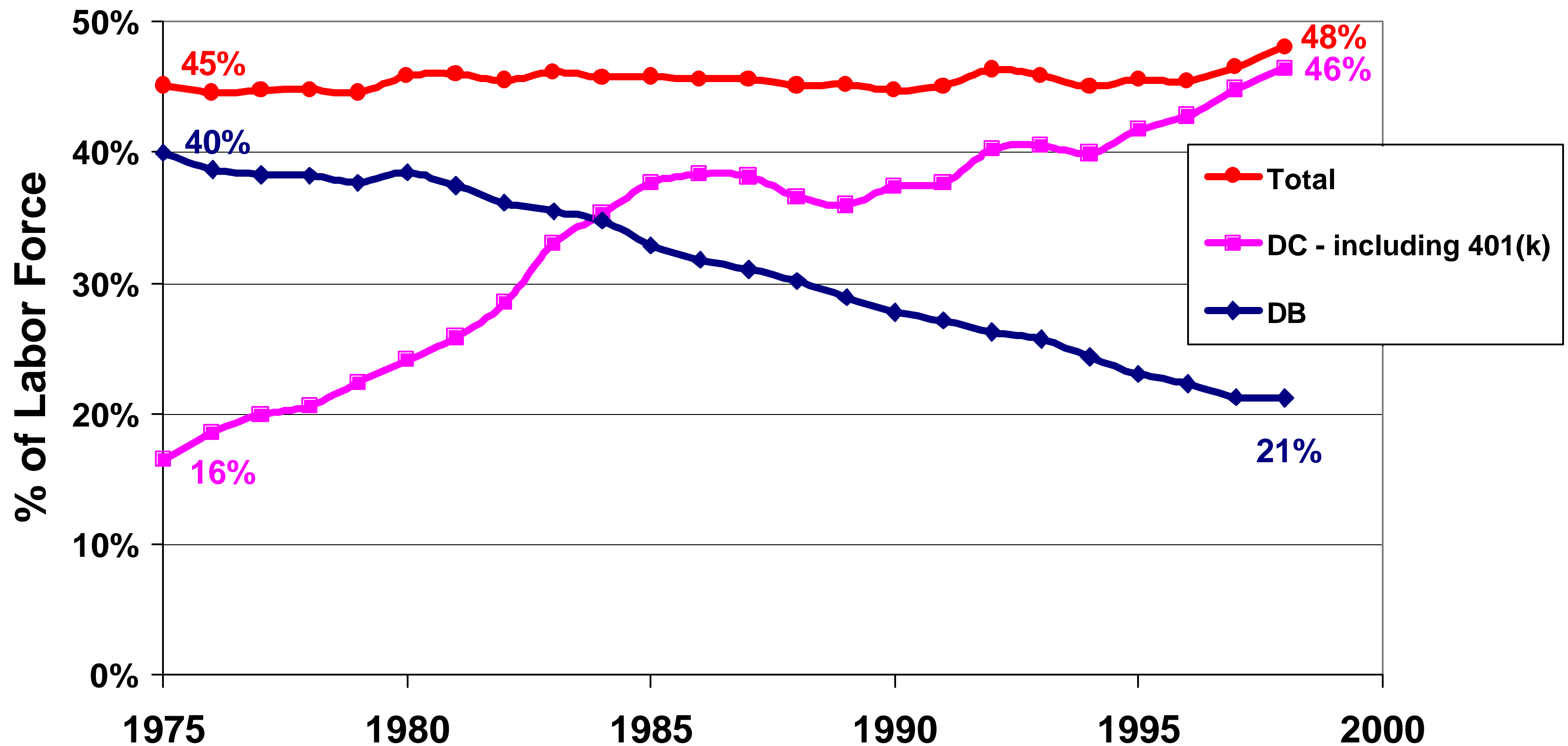
Accounting

The third factor is accounting, which should remain outside the scope of legislation. The stakeholders are owners of the company, analysts, and Securities and Exchange Commission (SEC) shareholder lenders. Their focus is to accurately assess the impact the DB plan has on business. Changes in the perspective on how DB plans should be reflected on a corporation's balance sheet have been significant and will likely continue to reflect the emerging view of higher transparency of accounting and measuring the obligation in the near future. There should continue to be a dividing line between the valuation of a DB plan obligation for assessing the financial status of a company and the valuation of the DB as a long-term contract with employees for funding and solvency. It is important that measures to address solvency and funding do not get confused with the accounting treatment of DB plans. Techniques such as the use of a bond yield curve can be defended as providing a more accurate value of the liability based on a plan's projected cash flows. This level of spot rate accuracy may be important in a market assessment environment, but may not necessarily provide the type of information for sound long-term decisions when it comes to cash requirements and funding policy.

Final Remarks

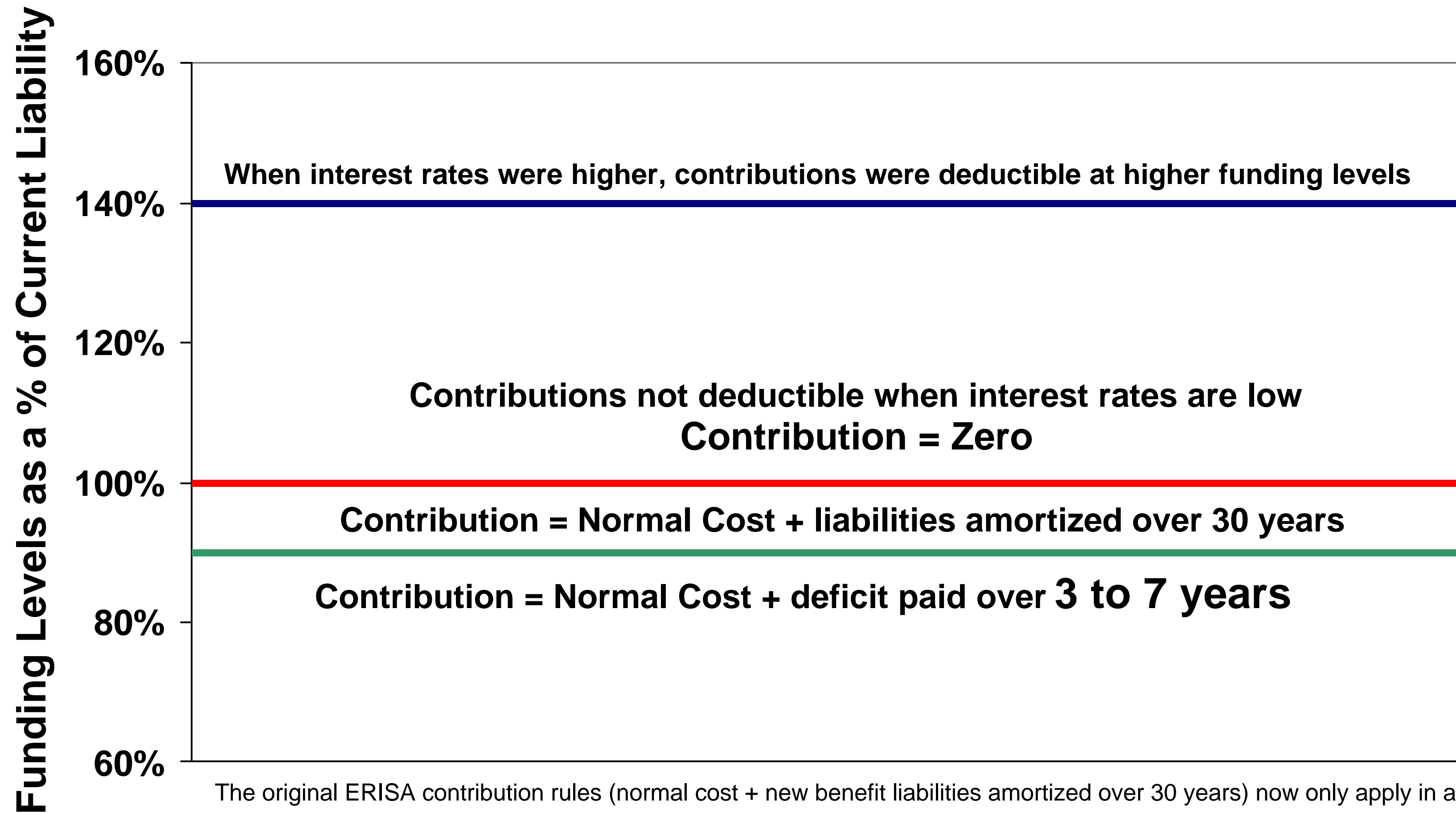
Defined benefit plans, once the most common form of retirement security for America's workers, have lost much of their attraction for corporations. The complicated solvency rules after three years of low interest rates and market returns have created a funding crisis for DB plans. At the same time, plan participants are starting to appreciate the value of being covered by a DB plan. Employees are beginning to recognize the value of the commitment and insurance element of pooling both investment risk and mortality risk through a company-sponsored plan. As a nation, we need to be equally concerned about the significant future number of retirees who may only have account balances to rely on to supplement Social Security benefits at retirement. The high risk of personal ruin through individual self-annuitization is yet to be fully realized.

Chart I - Participation Rates in Pension Plans (by type)



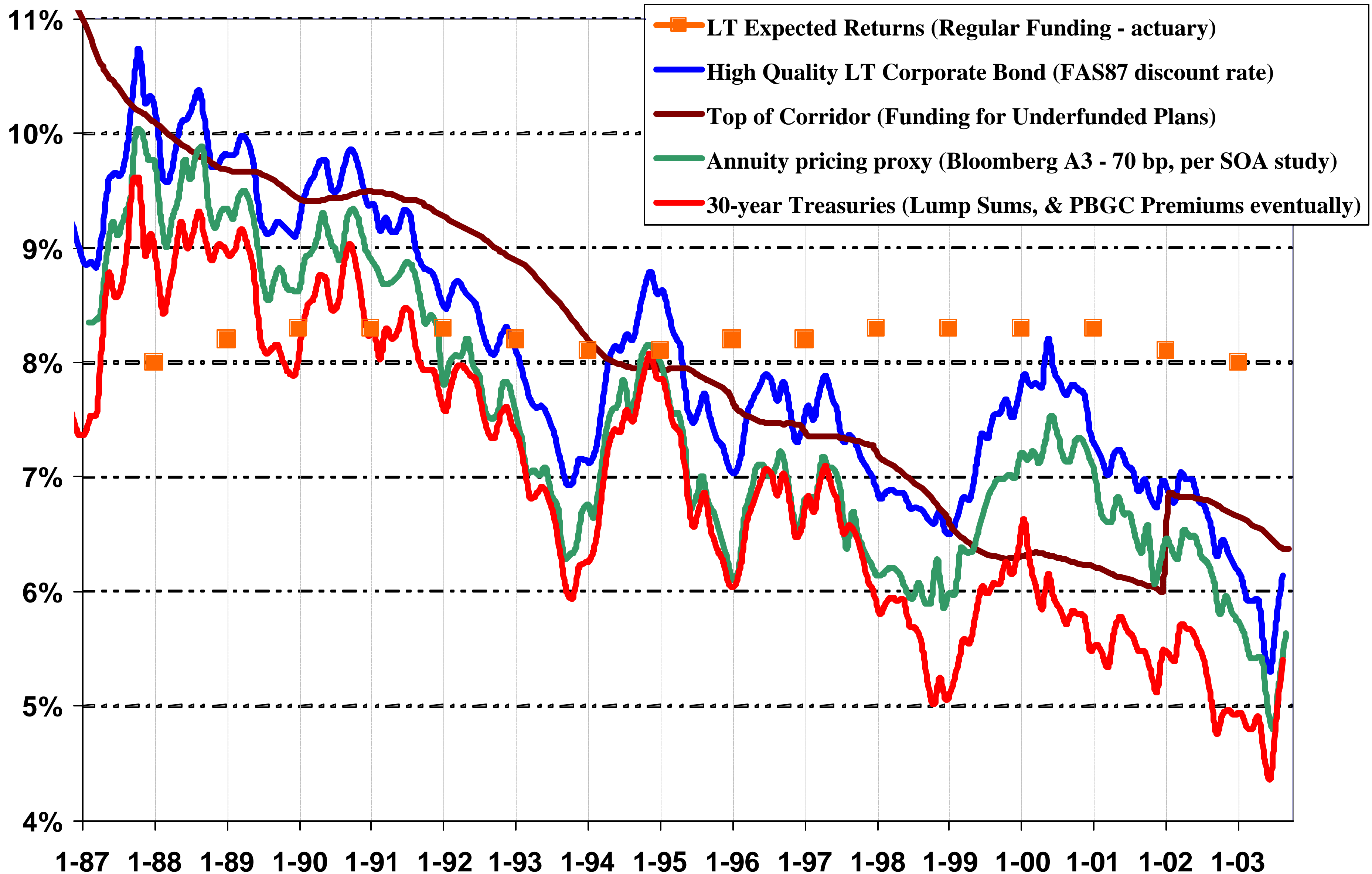
About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both. Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

Allow Contributions in Good Years



The original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). At one time they applied to all plans. The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. The expected returns are from Watson Wyatt surveys.