# TESTIMONY OF SCOTT MACEY

**ON BEHALF OF THE**

## AMERICAN BENEFITS COUNCIL

## BUSINESS ROUNDTABLE

## ERISA INDUSTRY COMMITTEE

## FINANCIAL EXECUTIVES INTERNATIONAL

## NATIONAL ASSOCIATION OF MANUFACTURERS

**AND**

## US CHAMBER OF COMMERCE

**BEFORE A HEARING OF THE**

## UNITED STATES SENATE

## SPECIAL COMMITTEE ON AGING

**ON**

## AMERICA'S PENSION SYSTEM

**OCTOBER 14, 2003**

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is Scott Macey, and I am Senior Vice President of Aon Consulting. Today, I am serving as a spokesman for the American Benefits Council, the Business Roundtable, the ERISA Industry Committee, Financial Executives International, the National Association of Manufacturers, and the US Chamber of Commerce – organizations that represent a broad cross-section of American business. These organizations come before you with a single voice to emphasize the need to preserve our nation's voluntary, employer-sponsored defined benefit system.

Defined benefit plans and the employers that voluntarily sponsor them confront unprecedented burdens – some caused by temporary economic conditions, but others caused by arcane, obsolete, and excessive government regulations. A case in point is the requirement that pension funding and related obligations be calculated using the defunct 30-year Treasury securities rate that artificially inflates required contributions. This defunct interest rate (and the uncertainty as to what will replace it) is layered on top of counter-productive and inflexible funding rules, widespread exposure to unwarranted litigation, and an environment that is hostile to the type of adaptation that is necessary if defined benefit plans are to survive in the 21st Century. Moreover, all this is occurring at the same time that defined benefit plans face an unprecedented combination of low interest rates, stock market declines, and an economy struggling to grow.

Our defined benefit pension system stands at a crossroads. Congress confronts a fundamental choice – whether to continue down the current road of an inflexible funding and regulatory regime that is illogical and imposes untenable burdens or whether to chart a new path toward a vibrant and growing defined benefit system.

Given all these pressures, it should come as no surprise that employers are increasingly abandoning defined benefit pensions, leaving open the question of whether defined benefit plans will continue to be available to American families on a wide-spread basis in the future. Fortunately, many of the challenges facing the system can be addressed in a positive manner that will enable employers to continue providing financially sound pension programs to their

employees. But action to strengthen the defined benefit system must be taken now – beginning with Congress promptly replacing the obsolete 30-year Treasury rate.

At the same time, it is critical that Congress not overreact to temporary conditions by rushing to enact major reforms (such as the recently floated "yield curve" concept) that have not been adequately analyzed. Our pension statutes are complex and interrelated, and reform should not be adopted on a piecemeal basis. Pension changes can have dramatic effects on plans, employers, and employees – as well as on equity and bond markets and the economy as a whole. Reforms should be considered carefully, with due consideration for their likely impact, and be based on comprehensive analysis. In evaluating changes, Congress must remember that tens of millions of American workers and retirees rely on defined benefit plans as a critical element of their retirement security. We owe it to those Americans and their families to ensure that changes, no matter how well intentioned, are not counter-productive.

The policy decisions that Congress makes in the near future could tip the balance one way or the other – toward a vibrant retirement system that continues to offer employers and individuals realistic options under both defined benefit and defined contribution plan designs or toward a more narrow system in which defined contribution plans are the only retirement plan available to most workers. In evaluating any proposals, it is critical to recognize that the U.S. pension system is voluntary. Employers are not required to offer employees a retirement plan. And most importantly, although these plans no doubt benefit companies in attracting, retaining, and rewarding employees, the overwhelming beneficiaries of the defined benefit system are American workers and their families. To create a robust system, the government must make it clear to employers that it supports their sponsorship of retirement plans – including defined benefit plans. Congress and the Executive Branch can show the necessary support for the retirement system through their own public statements, by providing clear guidance to employers on how to start and maintain plans, and most importantly by formulating laws that provide a clear, flexible, and responsive framework. Defined benefit plans have suffered for years from a regulatory regime that on the one hand is overwhelmingly detailed, complex, and inflexible and on the other hand fails to provide the necessary structure or support for new plan designs such as hybrid plans.

We stand ready to work – together with Congress and the Administration – to find solutions to strengthen and preserve defined benefit pension plans and protect American workers, and urge the members of this Committee and Congress to consider the following key points.

- The obsolete 30-year Treasury rate that is required to be used for pension calculations should be replaced immediately with a rate based on a composite blend of the yields on high-quality corporate bonds
- The defined benefit system provides hundreds of billions of dollars of retirement income to millions of Americans. Proposed changes to the defined benefit system should be adopted only after careful review and analysis, including input from plan sponsors and participants. .
- Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform of the pension funding rules.
- Some modest modifications to the current funding regime (e.g., increasing the tax-deductibility of pension contributions, elimination of rules that contribute to funding volatility) should be considered to increase its effectiveness.
- Requiring use of a spot-rate yield curve (as proposed by the Treasury Department and adopted by the Senate Finance Committee) would involve a significant change in our pension system to a volatile and complicated regime, and should not be adopted.
- It is important that any new disclosure requirements be responsible and serve a clearly defined need, and that any misleading or duplicative disclosure requirements be rejected.
- While the Pension Benefit Guaranty Corporation's (PBGC) deficit should be evaluated and monitored, the long-term financial position of the PBGC is strong, and analogies to the savings and loan (S&L) crisis are misplaced. More informative measures of the PBGC's solvency should be developed and publicized.
- Congress should not prevent the Treasury Department and IRS from resolving outstanding legal issues involving hybrid pension plans.

**Background on Defined Benefit Plans –** Defined benefit plans offer a number of features critical for employees' retirement security.

- Benefits are funded by the employer (and do not typically depend upon employees making their own contributions to the plan).
- Employers bear the investment risk in ensuring that earned benefits are paid.
- Benefits are guaranteed by the federal government through the plan sponsor-funded PBGC.
- Benefits are offered in the form of a life annuity that assures participants and their spouses who elect this form of payment will not outlive their retirement income.

The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances) have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

As of 1998 (the most recent year for which official Department of Labor statistics exist), approximately 42 million Americans were participants in defined benefit pension plans.[1] In that year alone, more than 18 million retirees received benefits from defined benefit plans totaling over $111 billion (almost half of all benefits received from private-sector, employment-based retirement plans).[2] Without these hundreds of billions of dollars in benefits, fewer American families would be able to achieve a secure retirement. Yet while the defined benefit system helps millions of Americans achieve retirement income security, it is a system in which fewer and fewer employers are encouraged to participate because of deficient public policy provisions. The total number of government-insured defined benefit plans has decreased from approximately 114,500 in 1985 to fewer than 33,000 such plans in 2002.[3] Looking at this decline over just the past several years makes this downward trend all the more stark. From 1999 through 2002, there has been a decrease of over 7,500 defined benefit plans – from 39,882 to 32,321 plans – or 19 percent in just <u>three years</u>.

Even more disheartening, the statistics quoted above do not even take into account pension plans that have been frozen by employers (rather than terminated), an event that, like termination, results in no new pension benefits for existing employees and no pension benefits whatsoever for new hires. If frozen plans were tracked (and they clearly have been on the increase in recent months), the decline of our nation's defined benefit pension system would be even more

[1] U.S. Census Bureau, Statistical Abstract of the United States: 2002, No. 524.
[2] U.S. Census Bureau, Statistical Abstract of the United States: 2002, No. 524.
[3] 2002 PBGC Annual Report, page 13.

apparent. And unfortunately, there are virtually no examples of frozen plans "thawing out" such that benefits begin to accrue once again. Once the plans are frozen, employees accrue no further benefits. Of course, these facts are sobering from both a human and policy perspective.

**Pension Plan Funding Generally –** Pensions are a long-term commitment. They are both funded and disbursed over decades. Recently, concerns have been raised about the funded status of many defined benefit plans. Much of the deterioration in pension funding that we see today is attributable to the current unique combination of historically low interest rates and historically depressed asset values. Also, the mandated use of the artificially low interest rate on 30-year Treasury bonds, that are no longer even issued by the Treasury Department, which I will discuss in more detail below, artificially inflates liabilities, and consequently makes a plan's funding level seem lower than it really is when viewed in the proper perspective of a long-term commitment.

Policymakers should not make the mistake of assuming that the recent business cycle indicates a need for wholesale reform of the pension funding rules. It does not. Recent market and interest rate conditions should be expected to produce temporary funding deficiencies that will correct as conditions improve and once Congress replaces the obsolete 30-year Treasury rate. We have, in fact, seen the beginning of such corrections over the past few months. In fact, it would be an anomalous situation if there was not a downturn in funding of typical pension plans during periods of general economic downturn coupled with low interest rates.

It is also important to note that the swing from the abundant pension funding levels of the 1990's to the present state of deficits for many plans has been exacerbated by the counterproductive pension funding rules adopted over the last few decades. Beginning in the 1980's, defined benefit plans were subjected to layer upon layer of ill-advised laws and burdensome regulation, often overlapping and sometimes contradictory and too often enacted as a means of raising federal revenue. These changes included limits on the ability of companies to contribute to their plans by lowering the maximum deductible contribution, imposing a significant excise tax on nondeductible contributions, and placing heavy penalties on withdrawals of surplus assets. In 1997 and after, some limited relief was provided, but the overall result is that our laws and

regulations strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level. While hasty and radical reform would be unwise, some modest modifications to the current funding rules could be considered to increase their effectiveness without impairing the attractiveness of defined benefit plans to employers. Such modifications could include increasing the tax-deductibility of pension contributions to encourage financial cushions in plans and elimination of rules that exacerbate the volatility of required pension contributions to protect against economic downturns.

**Replacement of the Obsolete 30-Year Treasury Rate –** The need to replace the obsolete 30-year Treasury rate used for pension calculations is the most pressing issue facing the defined benefit pension system today, and cries out for immediate resolution. Prompt action is required to correct the problem in order to prevent a further exodus of employers from the defined benefit system.

Under current law, employers that sponsor defined benefit pensions are required to use the 30-year Treasury 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 PBGC. The various provisions of federal law requiring use of the 30-year Treasury 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 thought to be an acceptable proxy for other long-term investments. While a variety of rates were discussed when the 30-year Treasury rate was first selected in 1987, it was believed at the time that it reflected the appropriate benchmark whereby companies could reasonably set aside appropriate assets to meet their long-term funding obligations. That assumption is no longer valid.

In 1998, the U.S. Treasury Department began retiring federal debt by buying back 30-year Treasury bonds. In October 2001, the Treasury Department discontinued issuance of 30-year 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 interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other debt instruments. In testimony before Congress, Bush Administration officials have stated that, "[The] Treasury Department does not believe that using the 30-year Treasury bond rate produces an accurate measurement of pension liabilities."[4]

The result is that pension liabilities are inflated, and employers are required to make excessive pension contributions (often three or four times what was anticipated) and PBGC variable rate premium payments. Perhaps more than any other factor, these inflated and uncertain financial obligations imposed on employers have contributed to the spate of plan freezes and terminations in recent years.

Today's inflated funding requirements harm the economy and have a direct adverse impact on many workers since cash inappropriately mandated 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 reasonably 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. Indeed, some employers may be forced to lay off employees in order to finance the required cash contributions to their pension plans. 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 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.

Due to these problems and the fact that use of an obsolete interest rate for pension calculations makes no sense from a policy perspective, Congress provided in the March 2002 economic stimulus act a temporary interest rate adjustment that expires at the end of this year. Since 2002,

[4] 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).

the 30-year Treasury rate has only become progressively more obsolete, and the associated problems described above have become more grave. In short, the 30-year Treasury rate is an obsolete rate that must be replaced.

We strongly urge that Congress replace the defunct 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. A corporate bond blend steers a conservative course that fairly and appropriately measures pension liabilities. High-quality corporate bond rates are known and understood in the marketplace, and are not subject to manipulation. A benchmark based on such rates would also provide the predictability necessary for a company to plan its pension costs and the role such costs play in their business.

Use of such a conservative corporate bond blend would also ensure that plans are funded responsibly. 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. Thus, 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.

Senator Judd Gregg, Chairman of the Health, Education, Labor, & Pensions (HELP) Committee, has introduced a bill (S. 1550) that replaces the obsolete 30-year Treasury rate with a corporate bond blend for five years. We urge members of this Committee to co-sponsor S. 1550, and we recommend that the Senate promptly pass legislation that adopts a corporate bond blend beginning in 2004. Action as soon as possible is imperative. The House has already overwhelmingly passed a bill (H.R. 3108) by a vote of 397-2 providing for the use of a blend of high-grade corporate bond indices as the benchmark for funding plans for the next two years.

**Other Proposals Affecting Defined Benefit Plans –** Recently, a wide range of proposals have surfaced that are ostensibly designed to improve the defined benefit system. In our view, many of these proposals have not been sufficiently analyzed and could well further disincent

employers from establishing and maintaining defined benefit plans. We believe that if defined benefit pension plans are to be a vital component of retirement income security for American workers and their families in the future, the government must act in a thoughtful and helpful manner to create an environment that encourages rather than discourages responsible participation in the retirement system. Toward that end, the legislative and regulatory environment governing defined benefit plans should be transformed from one that is incomprehensible, volatile, and self-defeating to one that is understandable, predictable, and effective. The current forbidding and inhospitable environment – which discourages employers from establishing and preserving defined benefit plans – should be reformed to encourage the formation and continuation of these plans. However, as I have previously stated, any changes should be adopted only after careful review and analysis, including input from plan sponsors and participants and an understanding of the behavioral reactions that will occur among major stakeholders.

With these general observations in mind, let me briefly address concerns we have with respect to certain proposals that have been made.

*Yield Curve* – The Treasury Department has put forward a proposal to ultimately replace the 30-year Treasury rate with a so-called "yield curve" concept that raises a large number of serious concerns. Under this proposal, the interest rate used would, in effect, change based on a sliding scale yet to be constructed by the Treasury Department and based on an analysis of a spot-rate yield on corporate bonds of different durations. The Senate Finance Committee adopted a similar approach when it reported the National Employee Savings and Trust Equity Guarantee Act, a pension reform bill, on September 17, 2003.

Requiring use of a spot-rate yield curve would involve a significant change in our pension system to a volatile and complicated regime under which the interest rates used for measuring pension liability would be based on immediate spot rates and would vary with the schedule and duration of payments due to each plan's participants. The current law rules that allow employers to use the average of the relevant interest rate over several years to reduce funding volatility would be repealed. In addition, important flexibility would be lost by removing the existing

interest rate "corridor" that allows employers to use a range of the averaged 30-year Treasury rate for pension calculation. This corridor has historically been 90% to 105% of the averaged rate.

Although both Congress and we lack sufficient detail to fully analyze the yield curve approach, it raises a large number of policy concerns and unanswered questions. In fact, the entire yield curve concept seems to be based on an incorrect assumption that such an approach would add significant accuracy and precision to pension funding. In reality, a yield curve would seem to add only a veneer of accuracy while truly imposing complexity, volatility, and unpredictability to pension funding. Based on our current understanding of the concept, we are concerned that the yield curve would:

- ***Exacerbate funding volatility*** by subjecting pension liability calculations not only on fluctuations in interest rates, but also to changes in the shape of the yield curve (caused when rates on bonds of different durations move independent of one another) and to changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, etc.). As mentioned above, use of the average of the relevant interest rate over several years (as under current law) 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. 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.
- ***Make it difficult for employers to plan and predict their pension funding obligations*** (another significant impediment to defined benefit plan sponsorship today) due to the increased volatility and complexity described above.
- ***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. As mentioned above, the corridor surrounding the interest rate

also would be eliminated. The resulting loss of 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 employer sponsoring the pension) could affect the rate of a given bond index dramatically, thereby leading to distortions in pension calculations and even potential manipulation.
- ***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. The construction of the required yield curve would not be a transparent process or one easily understood by plan sponsors or monitored by Congress. Many judgments would have to be made regarding the appropriate bonds to be used to set the rate at each duration, including where available bonds of a particular duration provide widely varying rates of return.
- ***Influence the hiring and retention patterns of employers that sponsor defined benefit plans*** since some employees would be much more costly than others.
- ***Result in, at best, only a marginally more accurate measure of liabilities*** compared with the use of a corporate bond rate which represents a conservative middle course between the long-term rates of return actually earned by pension plans and the annuity rates charged by insurers to terminating plans. Pension plans are not like bank accounts or certificates of deposit, and should not be evaluated as if they are demand deposit-like obligations, rather than the long-term commitments that they are.

There are many additional unanswered questions created by the 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 on – and conversion to annuity values of – employee contributions to defined benefit plans, the payment of interest credits under hybrid pension plans, and the calculation of PBGC variable premium obligations.

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. Even the Treasury Department (which originally floated the yield curve concept) recognizes that such an untested change would require a complete reevaluation of our pension funding rules. 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 yield curve 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 and thoughtful review through deliberative Congressional study and the regular legislative process. This type of more fundamental review would be possible if Senator Gregg's pension rate replacement legislation (S. 1550) is enacted since it replaces the 30-year Treasury rate only through 2008. This window of time would allow Congress to decide whether additional changes are warranted.

*Proposals Regarding Disclosure and Other Requirements for Certain Plans* – The Bush Administration has also made proposals that would require additional disclosure of pension information and that would mandate freezes in certain private-sector pension plans. First, while we certainly support the goal of transparency of pension information, 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 is counter-productive. For example, the Administration's proposal to key disclosure off of a plan's termination liability (which is generally overstated) 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. 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 quite normal and appropriate. It should not be cause to trigger publication of private corporate

information on an ad hoc basis that would sound inappropriate alarm bells the actual impact of which would be to deter companies from maintaining defined benefit plans.

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, this proposal raises technical and policy issues that require further examination. For example, the Administration's proposal provides no definition of "junk bond" status. In addition, Congress should carefully consider 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.

**Financial Status of the PBGC –** The PBGC provides critical benefit security enjoyed by the millions of defined benefit plan participants. Businesses that voluntarily maintain retirement plans strongly believe that the PBGC should be operated and maintained on a sound financial basis, not only because it protects participants and retirees, but also because these businesses pay the premiums that support the PBGC.

Nonetheless, while the PBGC's deficit should be evaluated and monitored, we believe that the long-term financial position of the PBGC is strong. The current deficit is not a threat to the PBGC's viability, and it would be a mistake to be alarmed and overreact. Indeed, the PBGC has operated in a deficit position throughout most of its history. Nor does the shift from surplus to deficit over the course of one year suggest the need for an immediate change in the pension funding or premium rules in order to safeguard the health of the PBGC. Today, the PBGC's single-employer program has total assets in excess of $25 billion, and it earns money from investments on those assets.[5] While the PBGC currently reports liabilities of approximately $29 billion for its single-employer program, the annuity pension obligations underlying those

[5] PBGC 2002 Annual Report, page 30.

liabilities come due over many decades,[6] during which time the PBGC can be expected to experience investment gains to offset any "paper" deficit that exists today. It should also be noted that these liability projections by the PBGC are based on unrealistic interest rate and mortality assumptions, which make liabilities appear larger than they actually are.

It is also important to remember that when the PBGC takes over a plan, it assumes all of the plan's assets, but not all of its liabilities. Instead, the PBGC insures a maximum guaranteed normal retirement age benefit for each participant ($43,977 for 2003). While this limits the benefits of some pensioners, it also serves to limit the maximum exposure of the PBGC. In addition, the PBGC gains control of the assets at the time of termination, but will pay benefits only over subsequent decades. The substantial assets that the PBGC holds and the relatively modest size of its deficit when viewed in the context of its capped and long-term liabilities ensures that the PBGC will remain solvent far into the future even under current rules and economic conditions – a point that the PBGC itself has acknowledged repeatedly.

As the title of this hearing suggests, some have attempted to draw an analogy between the PBGC's financial condition and the savings and loan (S&L) crisis. We believe that such comments misapprehend the actual circumstances faced by the agency. Most important, as just discussed, the PBGC's long-term financial position is strong. In addition, the downward spiral of S&Ls making riskier and riskier investments in an attempt to remain competitive is completely inapplicable given the PBGC statutory mandate to prudently manage its assets and its insulation from competition. Moreover, the PBGC is an entirely different entity than an S&L guarantor. Perhaps most significantly, S&L depositors had the ability to demand the full amount of their deposits at any time, raising a genuine risk of lack of sufficient funds and creating a fertile ground for financial panic. When assets were insufficient to meet consumer demand for deposits, the government was forced to step in and make up the difference. In contrast, the PBGC is only required to pay benefits as they become due, and those insured by the PBGC have no right to demand their full benefits at any time. As a result, there is no comparable immediate risk to the government of having to step in to compensate for insufficient funds.

[6] The PBGC does not make lump sum payments even if the terminated plan provided for such payments.

At this point in time, we do not believe that the PBGC's finances should be cause for alarm. In times of economic hardship, more pension plans (and the companies that sponsor them) confront economic difficulty (including bankruptcy), more pension plans suffer declines in asset values, and more pension liabilities are assumed by the PBGC. At the same time, the PBGC may enjoy sub-par investment gains on its assets. As the economy improves, this cycle reverses itself, returning the PBGC to robust financial health.

Moreover, we believe that more informative measures of the PBGC's solvency should be developed and publicized. For example, in presenting its financials, the PBGC should place greater emphasis on its long-term ability to pay benefits as well as on average claims over time; it should use a more realistic discount rate in calculating its liabilities consistent with long-term return expectations; and it should develop a transparent and consistent mechanism for reporting "probable" and "possible" terminations.

**Threats Facing Hybrid Pension Plans –** One rare source of vitality in recent years within our defined benefit system has been hybrid pension plans (such as cash balance and pension equity). Hybrid plans were developed in part to correct a mismatch between the traditional pension design and the needs of today's mobile workers. The traditional pension design disproportionately awards benefits to employees with very long service relative to employees with less than career-long employment at their firm. Today, however, most employees change jobs frequently. Indeed, numerous studies show that, in our mobile workforce, the more even benefit accrual formula of hybrid pension plans delivers higher benefits to the vast majority of workers. At the same time, hybrid plans include the features that make traditional defined benefit pension plans popular with employees – namely, an insured, employer-funded benefit with lifetime annuity distribution options for which the employer bears the investment risk. Today, according to the PBGC, there are more than 1,200 hybrid pension plans in the U.S., covering more than 7 million employees.

While these plans offer a ray of hope for the future of our defined benefit system, hybrid plans also face serious threats that, if not addressed, will lead to their extinction. An overriding problem for these plans is that the rules applicable to defined benefit plans are stuck in the past,

and have not been updated to reflect the development and adoption of hybrid pension plans. The result of these outdated rules is that a number of pressing compliance issues regarding hybrid plans have been left unresolved.

Pending at the relevant federal regulatory agencies are several projects to provide much-needed guidance on these issues, such as the proper calculation of benefits in cash balance plans and the proper application of age discrimination standards to hybrid plans. These projects must be completed. However, some who believe that traditional defined benefit plans are the only type of pension design that should be allowed for certain employees have attempted to use the current appropriations process to deny funding for these regulatory projects. In particular, some in the House have used the Transportation-Treasury appropriations bill (H.R. 2989) as a vehicle to express concern about controversies involving isolated cash balance plan conversions, but have done so by seeking to deny Treasury funding to complete pending regulatory projects on hybrid plans.[7] Any such efforts that might arise in the Senate to affect complex pension policy through the appropriations process should be rejected. If the Treasury Department and IRS are prevented from resolving the outstanding legal issues involving hybrid pension plans, the resulting uncertainty will lead many employers to abandon these plans so that fewer Americans have pension coverage.

We are also concerned about legislative proposals (such as those embodied in S. 825 from Senator Tom Harkin) that would mandate that employers converting a traditional defined benefit plan to a hybrid pension plan allow employees to elect at retirement whether they wish to receive the hybrid pension plan benefit or a benefit under the traditional defined benefit plan in place at the time of the conversion. Our voluntary pension system is premised on the idea embodied in current law that benefits already earned are absolutely protected (the "anti-cutback" rule) but that employers have flexibility to adjust to changing circumstances by increasing or decreasing benefits that will be earned in the future. Under the mandated choice legislation, however,

[7] These efforts, led by Representative Bernie Sanders (I-VT), have pointed to a lone federal district court decision in *Cooper v. IBM* (2003 U.S. Dist. LEXIS 13223 (July 31, 2003)) that hybrid pension plans are age discriminatory. The *Cooper* decision is inconsistent with other federal court decisions, contrary to Treasury Department proposed regulations, and not supported by the legislative history or structure of the pension age discrimination statute. Under the decision's extremely flawed logic, simple compound interest would be illegal in pension plans. Even the Social Security program would be deemed illegal if the *Cooper* decision were applied to it.

businesses would be unable to alter future benefit levels in conjunction with a conversion as employees could simply choose to receive benefits under the prior formula. Yet business circumstances – such as increased international competition, significant workforce change, the presence of competitor firms with lower or no pension expense, possible company bankruptcy, the need to attract new workers, or employee preference for a reallocation of benefit dollars – sometimes necessitate adjustments to pension plans. And, moreover, the mandated choice proposals would add an element of severe uncertainty to pension funding since employers would not be able to ascertain what benefits to fund.

In no other area do we prevent employers from altering employment conditions in such a manner. Employers may cease employing individuals, change pay levels, alter working conditions, revise health coverage, even drop or freeze a pension program. Yet under the mandated choice proposals, employers that adopt a hybrid pension must keep the prior traditional pension forever for current employees. This would radically depart not only from the norms of our voluntary pension system but indeed from basic American workplace principles, forcing prudent businesspeople – who will be unable to make these unalterable benefit commitments – to depart the defined benefit system as quickly as possible. Congress should reject these types of unhelpful mandated choice requirements that may seem to have some superficial appeal in protecting participants but in reality would only result in hurting them.

The cumulative effect of the various assaults on hybrid plans discussed above has been to jeopardize the existence of one of the only viable defined benefit designs that is able to provide meaningful benefits to employees in the economic and business environment of the 21st century. These threats to hybrid pension plans must be removed.

**Additional Defined Benefit Issues of Importance –** Finally, I want to mention briefly two other policy issues of importance to the defined benefit system.

*Making the 2001 Pension Reforms Permanent* – The 2001 tax act contained a number of very positive changes to the rules governing defined benefit plans. These included repeal of artificial funding caps, increases in the benefits that can be paid and earned from defined benefit plans,

and simplifications to a number of defined benefit plan regulations. We support making the 2001 retirement savings reforms, which are scheduled to sunset at the end of 2010, permanent so that employees and employers can have the long-term certainty so necessary for pension planning purposes.

*Pension Accounting* – We are also concerned about ominous developments concerning the accounting standards for pension plans. While the accounting issues are still in flux, we wanted to make the Committee aware of this added source of potential strain on the defined benefit system. Accounting standard-setters, led by those in the United Kingdom, are pushing to require companies to reflect the full fluctuation in pension asset gains and losses on the firm's financial statements *each year*, thereby prohibiting companies from amortizing such results over a period of years as they do under today's accounting standards. This new "mark-to-market" approach is inconsistent with the long-term nature of pension obligations, produces extreme volatility in annual corporate income, and has prompted 75 percent of British pension sponsors to consider terminating their plans. Given the many other challenges faced by sponsors of defined benefit plans, abandonment of current U.S. accounting standards for this "mark-to-market" approach would be devastating.

**Conclusion**

Thank you, Mr. Chairman, for the opportunity to present the views of the business community on how to maintain a viable and strong pension system. Defined benefit plans offer many unique advantages for employees, and the employers that sponsor these pension plans sincerely believe in their value. Without prompt action by Congress and the Administration, however, these plans will increasingly disappear from the American pension landscape. Working together, we can prevent this tragic result.

I would be pleased to answer whatever questions you may have.