MORTGAGE INVESTMENTS BY PENSION FUNDS AND TAX TREATMENT OF CERTAIN CHURCH RETIREMENT ANNUITIES

HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1910

MAY 19, 1982

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MORTGAGE INVESTMENTS BY PENSION FUNDS AND TAX TREATMENT OF CERTAIN CHURCH RETIREMENT ANNUITIES

WEDNESDAY, MAY 19, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON SAVINGS,
PENSIONS, AND INVESTMENT POLICY,
Washington, D.C.

The committee met, pursuant to notice, at 9:37 a.m., in room 2221, Dirksen Senate Office Building, Hon. John H. Chafee (chairman) presiding.

Present: Senators Chafee, Dole, and Bentsen.

[The press releases announcing the hearing and the prepared statements of Senators Chafee and Dole follow:]

[Press release No. 82-128, May 3, 1982]

FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY SETS HEARING ON MORTGAGE INVESTMENTS BY PENSION FUNDS AND TAX TREATMENT OF CERTAIN CHURCH RETIREMENT ANNUITIES

Senator John H. Chafee (R., R.I.), Chairman of the Subcommittee on Savings, Pensions, and Investment Policy announced today that the Subcommittee will hold a hearing on Monday, May 17, 1982, on mortgage investments by pension funds and tax treatment of certain church retirement annuities.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Chafee noted, "It is increasingly clear that the traditional sources of home financing, that is, savings deposits in thrift institutions, will not be adequate to satisfy future demands for mortgage loans. Additionally, some experts in the pension and housing industries believe that current ERISA laws and regulations act as an impediment to prudent pension fund investments in the mortgage market. Removing any impediments to pension fund investments in home mortgages involves important policy questions concerning the goal of pension fund investments. The Subcommittee is interested in hearing testimony from witnesses about any impediments that currently exist in the ERISA statute or regulations that inhibit mortgage investments by pension funds, and the corrective actions that should be considered." In addition, Senator Chafee stated, "The Subcommittee is also interested in specific testimony on the Department of Labor's current class exemption efforts regarding pension fund investments in residential housing financing.

The Subcommittee will also hear testimony on S. 1910, introduced by Senator Bentsen for himself and others. S. 1910 would generally modify the tax treatment of certain retirement annuities for clergymen and lay employees.

[Revised press release No. 82-128, May 13, 1982]

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY RESCHEDULES HEARING ON MORTGAGE INVESTMENTS BY PENSION FUNDS AND TAX TREATMENT OF CERTAIN CHURCH RETIREMENT ANNUITIES

Senator John R. Chafee (R., R.I.), Chairman of the Subcommittee on Savings, Pensions, and Investment Policy, announced today that the Subcommittee is rescheduling its hearing on mortgage investments by pension funds and tax treatment of certain church retirement annuities. The hearing was originally announced for May 17, 1982. The new date for the hearing is Wednesday, May 19, 1982.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

STATEMENT BY SENATOR JOHN H. CHAFEE, CHAIRMAN, SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, COMMITTEE ON FINANCE

Good morning. The Primary focus of this hearing is on issues affecting the investment of private pension funds in the home mortgage market. We are not considering any specific legislation in this regard.

We all know about the condition of the U.S. housing industry. High interest rates in the 16- to 17-percent range have kept a lid on new housing starts, as well as existing home sales. In the first quarter of this year, housing starts were at their lowest level in the entire postwar period, 178,000 units. Existing home sales had their worst first quarter since 1970, recording only 420,000 transactions.

In addition to a cloudy future for long-term mortgage interest rates, the housing industry faces an even more basic uncertainty: The rapidly changing structure and functions of our financial institutions raise questions about how home mortgages will be financed in the coming decade.

Only one thing has become clear—that traditional soures of home mortgage loans, savings deposits in thrift institutions, will not be adequate to satisfy the demands of future home buyers.

Whenever the issue of adequate investment capital is raised, inevitably eyes turn toward the pension industry which manages over half a trillion dollars in retirement funds. And, inevitably, suggestions have come from some housing and pension experts that if ERISA or its regulations were eased, we might stimulate substantial new investments in the lagging housing market.

That is what this hearing is about. We want to hear from the experts what they perceive to be needless impediments to prudent pension fund investments in home mortgages. We also want to know what solutions they propose to this problem consistent with the principle that pension funds should be managed in the best interests of their current and future beneficiaries.

Finally, I hope each witness would give his thoughts about the extent to which pension funds, with their vast pool of capital, will or can offer relief to the housing industry.

We want to encourage open discussion of these issues. By scheduling this hearing, there is no suggestion whatever that we would advocate any mandatory pension fund investments, or that we would tolerate any kind of investments that would undermine the rights and interests of pension beneficiaries.

I want that to be clear from the start.

STATEMENT OF SENATOR ROBERT DOLE

Mr. Chairman, I believe today's hearing on mortgage investments by pension funds and the tax treatment of certain church retirement annuities is an important hearing.

There has been a growing concern in this country over mortgage investments by pension funds. I believe this hearing should provide us with an opportunity to hear about any impediments in current ERISA rules or regulations that would prohibit mortgage investments by pension funds.

Mr. Chairman, your interest in providing more opportunities for everyone to share in homeownership is well documented. I look forward to hearing our witnesses this morning with great interest.

Mr. Chairman, I would also like to thank you for having this hearing on S. 1910. This bill will modify several provisions of the Internal Revenue Code that unfairly obstruct the acceptable accumulation of retirement benefits for the majority of clergymen and lay employees of the church denominations in this country. This legislation will accord ministers and lay employees the same right of contribution to their retirement annuities that other classes of employees now enjoy. It represents a major step toward assuring our ministers and lay employees of adequate retirement allowances.

I look forward to working with Treasury to clarify any technical problems with this legislation so it can move forward.

Mr. Chairman, again thank you for having this hearing on S. 1910 and for your support in our efforts to stimulate retirement savings.

II

97TH CONGRESS
1ST SESSION

S. 1910

To amend sections 403(b)(2) and 403(b)(3) of the Internal Revenue Code of 1954 with respect to computation of the exclusion allowance for ministers and lay employees of a church; to add a new section 403(b)(9) to clarify that a section 403(b) annuity contract includes an annuity contract of a church, including a church pension board; to conform section 403(c) with recent amendments to section 402(a)(1); to amend section 415(c)(4) to extend the special elections for section 403(b) annuity contracts to employees of churches or conventions or associations of churches and their agencies; to add a new section 415(c)(8) to permit a de minimis contribution amount in lieu of such elections; and to make a clarifying amendment to section 415(c) by adding a new paragraph (9) and conforming amendments to sections 415(d)(1), 415(d)(2), and 403(b)(2)(B).

IN THE SENATE OF THE UNITED STATES

DECEMBER 4 (legislative day, NOVEMBER 30), 1981

Mr. BENTSEN (for himself and Mr. DOLE) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend sections 403(b)(2) and 403(b)(3) of the Internal Revenue Code of 1954 with respect to computation of the exclusion allowance for ministers and lay employees of a church; to add a new section 403(b)(9) to clarify that a section 403(b) annuity contract includes an annuity contract of a church, including a church pension board; to conform section 403(c) with recent amendments to section 402(a)(1); to amend section 415(c)(4) to extend the special elections for section 403(b) annuity contracts to employees of churches or conventions or associations of churches and their agencies; to add a new section 415(c)(8) to permit a de minimis contribution amount in lieu of such elections; and to make a clarifying amendment to section 415(c) by adding a new paragraph (9) and conforming amendments to sections 415(d)(1), 415(d)(2), and 403(b)(2)(B).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 403(b)(2)(B) of the Internal Revenue Code of 1954 is amended to read as follows:

"(B) ELECTION TO HAVE ALLOWANCE DETERMINED UNDER SECTION 415 RULES.—In the case of an employee who makes an election under section 415(c)(4)(D) to have the provisions of section 415(c)(4)(C) (relating to special rule for section 403(b) contracts purchased by educational institutions, hospitals, home health service agencies, and churches or conventions or associations of churches and organizations described in section 414(e)(3)(B)(ii)) apply, the exclusion allowance for any such employee for the taxable year is the amount which could be contributed (under section 415 without regard to section 415(c)(8)) by his employer under a plan described in section 403(a) if the annuity contract for the benefit of such employee were treated as a defined contribution plan maintained by the employer.".

SEC. 2. Section 403(b)(2) of the Internal Revenue Code of 1954 is amended by adding the following subparagraph:

"(C) NUMBER OF YEARS OF SERVICE FOR DULY ORDAINED, COMMISSIONED, OR LICENSED MINISTERS OR LAY EMPLOYEES.—For purposes of this subsection, all years of service by a duly ordained, commissioned, or licensed minister of a church, or by a lay person, as an employee of a church or a convention or association of churches or an organization described in section 414(e)(3)(B)(ii) of such church (or convention or association of churches) shall be considered as years of service for 1 employer, and all amounts contributed for annuity contracts by each such church (or convention of association of churches) or such organization, during such years for such minister or lay person, shall be considered to have been contributed by 1 employer. For purposes of the preceding sentence, the term 'church (or convention or association of churches)' shall have the same meaning as it does for purposes of section 414(e).".

SEC. 3. Section 403(b)(3) of the Internal Revenue Code of 1954 is amended by adding at the end the following sentence: "Notwithstanding the preceding sentences, the includible compensation of an employee described in paragraph (2)(C) is not less than twice the nonfarm income poverty guideline of a family unit of 4 who resides in the contiguous United States for the prior taxable year in accordance with regulations prescribed by the Secretary. Such regulations shall provide for procedures to establish and revise the nonfarm income poverty guideline which are similar to the procedures used by the Office of Management and Budget for programs in which the poverty line is a criterion of eligibility.".

SEC. 4. Section 403(b) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(9) CERTAIN ANNUITY CONTRACTS.—For purposes of this subsection, the term 'annuity contract' includes an annuity contract provided by a church or a convention or association of churches, including an organization described in section 414(e)(3)(A).".

SEC. 5. The last sentence of section 403(c) (relating to taxability of beneficiary under nonqualified annuities or under annuities purchased by exempt organizations) is amended by striking out "or made available".

SEC. 6. Section 415(c)(4) of the Internal Revenue Code of 1954 is amended to read as follows:

"(4) SPECIAL ELECTION FOR SECTION 403(b) CONTRACTS PURCHASED BY EDUCATIONAL ORGANIZATIONS, HOSPITALS, HOME HEALTH SERVICE AGENCIES, AND CHURCHES OR CONVENTIONS OR ASSOCIATIONS OF CHURCHES AND THEIR AGENCIES.—

"(A) In the case of amounts contributed for an annuity contract described in section 403(b) for the year in which occurs a participant's separation from the service with an educational organization, a hospital, a home health service agency, or a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the amount of the exclusion allowance which would be determined under section 403(b)(2) (without regard to this section) for the participant's taxable year in which such separation occurs if the participant's years of service were computed only by taking into account his service for the employer, as determined for purposes of section 403(b)(2), during the period of years (not exceeding 10) ending on the date of such separation.

"(B) In the case of amounts contributed for an annuity contract described in section 403(b) for any year in the case of a participant who is an employee of an educational organization, a hospital, a home health service agency, or a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the least of—

"(i) 25 percent of the participant's includible compensation (as defined in section 403(b)(3)) plus $4,000,

"(ii) the amount of the exclusion allowance determined for the year under section 403(b)(2), or

"(iii) $15,000.

"(C) In the case of amounts contributed for an annuity contract described in section 403(b) for any year for a participant who is an employee of an educational organization, a hospital, a home health service agency, or a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant the provisions of section 403(b)(2)(A) shall not apply.

"(D)(i) The provisions of this paragraph apply only if the participant elects its application at the time and in the manner provided under regulations prescribed by the Secretary. Not more than one election may be made under subparagraph (A) by any participant. A participant who elects to have the provisions of subparagraph (A), (B), or (C) of this paragraph apply to him may not elect to have any other subparagraph of this paragraph apply to him. Any election made under this paragraph is irrevocable.

"(ii) For purposes of this paragraph the term 'educational organization' means an educational organization described in section 170(b)(1)(A)(ii).

"(iii) For purposes of this paragraph the term 'home health service agency' means an organization described in subsection 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health and Human Services to be a home health agency (as defined in section 1861(o) of the Social Security Act).

"(iv) For purposes of this paragraph the term 'church or convention or association of churches' shall have the same meaning as it does for purposes of section 414(e).".

SEC. 7. Section 415(c) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(8) CERTAIN TOTAL ANNUAL CONTRIBUTIONS AND ADDITIONS NOT IN EXCESS OF $10,000.—In the case of a participant who is an employee of a hospital, an organization described in paragraph (4)(D), or an organization described in section 414(e)(3)(B)(ii), notwithstanding any other provision of this subsection, contributions and other additions for an annuity contract described in section 403(b) with respect to such participant, when expressed as an annual addition (within the meaning of subsection (c)(2)) to such participant's account, shall not be deemed to exceed the limitation of subsection (c)(1) if such annual addition is not in excess of $10,000.".

SEC. 8. Section 415(c) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(9) APPLICATION WITH SECTION 403(b)(6).—If the rights of an employee under an annuity contract described in subparagraphs (A) and (B) of section 403(b)(1) are forfeitable at the time any contribution is made to such contract and if the rights subsequently become nonforfeitable within the meaning of section 403(b)(6), this subsection applies to such contract as if the rights of the employee were nonforfeitable at such time.".

~~SEC. 9~~. Section 415(d)(1) of the Internal Revenue Code of 1954 is amended to read as follows:

"(1) IN GENERAL.—The Secretary shall adjust annually—

"(A) the $75,000 amount in subsection (b)(1)(A),

"(B) the $25,000 amount in subsection (c)(1)(A),

"(C) in the case of a participant who is separated from service, the amount taken into account under subsection (b)(1)(B), and

"(D) the $10,000 amount in subsection (c)(8),

for increases in the cost of living in accordance with regulations prescribed by the Secretary. Such regulations shall provide for adjustment procedures which are similar to the procedures used to adjust primary insurance amounts under section 215(i)(2)(A) of the Social Security Act.".

SEC. 10. Section 415(d)(2) of the Internal Revenue Code of 1954 is amended to read as follows:

"(2) BASE PERIODS.—The base period taken into account—

"(A) for purposes of subparagraphs (A), (B), and (D) of paragraph (1) is the calendar quarter beginning October 1, 1974, and

"(B) for purposes of subparagraph (C) of paragraph (1) is the last calendar quarter of the calendar year before the calendar year in which the participant is separated from service.".

SEC. 11. The amendments made by sections 1, 3, 5, 6, 7, 9, and 10 of this Act shall be effective for taxable years beginning after December 31, 1980. The amendments made by section 2 of this Act shall be effective in determining the exclusion allowance under section 403(b)(2) for taxable years beginning after December 31, 1980. Years of service prior to January 1, 1981, and thereafter shall be aggregated in accordance with these amendments. The amendment made by section 4 of this Act shall be effective for all taxable years prior and subsequent to January 1, 1981. The amendment made by section 8 of this Act shall be effective for all taxable years prior and subsequent to January 1, 1981, except that the taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to have such amendment not be effective with respect to contributions made prior to January 1, 1981.

96-536 O - 82 - 2

DESCRIPTION OF TAX BILL

(S. 1910)

RELATING TO

TAX TREATMENT OF CHURCH PENSION AND ANNUITY PLANS

INTRODUCTION

The Senate Finance Subcommittee on Savings, Pensions, and Investment Policy has scheduled a hearing on S. 1910 (introduced by Senators Bentsen and Dole) for May 19, 1982. The bill relates to tax-sheltered annuities and pension plans for ministers and lay employees of churches.

The first part of this document is a summary of the bill. This is followed by a more detailed description of the bill, including present law, explanation of the provisions, and effective dates.

I. SUMMARY

Present Law

Under present law, employers which are tax-exempt organizations and public schools may make contributions on behalf of their employees to purchase tax-sheltered annuities. The amount contributed by the employer for a tax-sheltered annuity is excluded from an employee's gross income to the extent that it does not exceed the employee's exclusion allowance (based upon the employee's pay and length of service). In computing an employee's exclusion allowance, service with the contributing employer and previous contributions by that employer are taken into account. In addition, tax-sheltered annuities are subject to the overall limitations on contributions and benefits generally applicalbe to qualified pension plans. Certain special elections (1) to increase the limitations on contributions for tax-sheltered annuities, or (2) to increase the amount of the tax-sheltered annuity contributions excludable from gross income, apply to church and non-church employees of educational institutions, hospitals, and home health service agencies, but not to other church employees.

S. 1910

The bill would provide that, with respect to a minister or lay employee of a church or certain organizations associated with churches, all years of service with the chruch, etc., and all contributions to tax-sheltered annuities by the church, etc., would be aggregated for purposes of determining the applicable limits on exclusions and contributions under tax-sheltered annuities. In addition, the special elections (1) to increase the limitation on contributions for tax-sheltered annuities, or (2) to increase the amount of the tax-sheltered annuity contributions excludable from gross income, would apply to ministers and lay employees of a church, etc. Also, the overall annual limitation on the contributions and for any employee eligible for the special elections would not be less than $10,000 and would be adjusted for post-1974 cost-of-living increases.

The bill would clarify that (1) certain annuities offered by a church, etc., would qualify as tax-sheltered annuities, even though they are not commercial annuities and that (2) amounts paid by an employer to purchase a tax-sheltered annuity contract are taken into account for the years for which actually contributed.

In addition, the bill would clarify that no amount payable to a beneficiary under a tax-sheltered annuity would be excludable in the beneficiary's income until actually paid.

The provisions of the bill generally would be effective for taxable years beginning after December 31, 1980.

II. DESCRIPTION OF THE BILL

A. Computation of the Exclusion Allowance

Present Law

Under present law, employers which are tax-exempt organizations (including churches) or public schools may make contributions on behalf of their employees to purchase tax-sheltered annuities (sec. 403(b)). The amount contributed by the employer for a tax-sheltered annuity is excluded from an employee's gross income to the extent of the employee's exclusion allowance. The exclusion allowance is generally equal to 20 percent of the employee's includable compensation from that employer times the number of the employee's years of service with that employer, and is reduced by amounts already contributed by the employer to purchase the annuity.

This formula for fixing an employee's annual exclusion allowance may not reflect the career pattern of a minister or lay employee of a church who moves from one employing organization to another employing organization within the church.

Explanation of Provision

The bill would provide that, with respect to a minister or lay employee of a church and associated organizations,[1/] all years of service with the church, etc., would be considered as service with one employer, and all contributions by the church, etc., would be considered to have been contributed by one employer. In addition, for purposes of determining the applicable exclusion allowance, the bill would impute a minimum compensation level related to the Office of Management Budget's nonfarm income poverty level guidelines for an average sized family.

B. Overall Contribution Limitations

Present Law

Employer contributions to purchase a tax-sheltered annuity contract for an employee are subject to the overall limit on contributions to tax-qualified defined contribution plans (e.g., fixed contribution pension plans). Under special rules, a participant who is an employee of an educational institution, hospital, or home health service agency may elect to compute the annual exclusion allowance solely by reference to the maximum annual

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1/ The definition of a church plan includes a plan maintained by a convention or association of churches or an affiliated organization whose principal purpose or function is the administration or funding of a plan or program to provide retirement or welfare benefits for church employees (sec. 414(e)).

employer contribution which could be made to a defined contribution plan under the overall limits on contributions under qualified plans. The special rules apply to employees of a church hospital, etc., but not to other church employees. Under the overall limits, annual additions[2] to tax-sheltered annuities and other defined contribution arrangemetns may not exceed the lessor of (1) $25,000 adjusted for post-1974 cost-of-living increases ($45,425 in 1982) or (2) 25 percent of the participant's compensation from the employer for the year. There is no provision allowing de minimis contributions to defined contribution plans.

In addition, to permit lower-paid employees to make catch-up contributions immediately before retirement, present law provides certain special elections (1) to increase these limitations on contributions for tax-sheltered annuities, or (2) to increase the amount of the tax-sheltered annuity contributions excludable from gross income. However, these elections apply to church and non-church employees of educational institutions, hospitals, and home ehalth service agencies, but not to other employees of churches.

The overall limits on contributions and benefits provide a de minimis rule with respect benefits under defined benefit pension plans. The de minimis rule applies only for a participant whose total retirement benefits under all defined benefit plans of the employer do not exceed $10,000. (This limit is not adjusted for cost-of-living increases). If the de minimis rule is not satisfied, annual benefits under defined benefit plans are limited to the lesser of (1) $75,000 adjusted for cost-of-living increases since 1974 ($136,425 in 1982), or (2) 100 percent of average compensation for the high three years of compensation.

Explanation of Provision

The bill would extend to church, etc., employees the special elections (1) to apply the overall limitations on contributions to a tax-sheltered annuity without regard to the separate limits for tax-sheltered annuities, and (2) to apply the special catch-up limits on theamount of the tax-sheltered annuity contributions excludable from gross income.

In addition, the bill would permit de minimis annual contributions of $10,000 without regard to either the overall limitations on contributions or the special catch-up elections. The $10,000 would be adjusted for post-1974 cost-of-living increases ($18,190 for 1982).

The bill would also clarify present law to provide that annual contributions to a tax-sheltered annuity contract would be considered annual additions in the year made, rather than in the year when they become nonforfeitable.

2/ Annual additions consist of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants.

C. Qualifying Tax-Sheltered Annuity Contracts

Present Law

Under present law, it is unclear whether tax-sheltered annuity contracts may be issued by organizations that are not insurance companies.

Explanation of Provision

The bill would provide that a tax-sheltered annuity contract may be issued by a church or a convention or association of churches or an associated organization (such as a pension board) whose principal purpose is the administration or funding of a plan or program for the provisions of retirement or welfare benefits for the employees of a church.

D. Constructive Receipt

Present Law

Under present law, amounts under a tax-sheltered annuity are includable in the beneficiary's income if paid or made available to the beneficiary.

Explanation of Provision

The bill would provide that a beneficiary would be taxed on amounts under a tax-sheltered annuity only when amounts are actually paid under the contract. The provisions parallels the income tax rule for tax-qualified plans which was added by the Economic Recovery Tax Act of 1981.

E. Effective Date

In general, the bill would be effective for taxable years beginning after December 31, 1982. The provision permitting the aggregation of all years of service with a church would be applicable to determine the exclusion allowance for taxable years after December 31, 1980. The provision which defines qualifying annuity contracts would be effective with respect to all taxable years (including all past years). The provision which treats all contributions as annual additions in the year made, rather than the year vested, would generally be effective with respect to all taxable years, unless the taxpayer otherwise elects not to have it apply with respect to contributions made prior to January 1, 1981.

Senator CHAFEE. I want to apologize that we have had to delay this hearing twice. But we look forward today to getting underway, and hearing from the witnesses.

The primary focus of this is on the issues affecting the investment of private pension funds in the home mortgage market. We don't have any specific legislation before us. We are seeking suggestions. There have been various talks that if only the pension plans would get more active in home mortgages in some fashion, the U.S. housing industry would be saved. Whether that is so or not—we will get some light shed on that today. Of course, the condition of the U.S. housing industry is no secret. High interest rates in the neighborhood of 16 plus percent have kept a lid on housing starts as well as sales of existing homes. In the first quarter of this year, housing starts were at their lowest level in the entire postwar period, 178,000 units in a quarter for the whole country.

Existing home sales had their worst first quarter since 1970, recording only 420,000 actions. In addition to a cloudy future for long term mortgage interest rates, the housing industry faces an even more basic uncertainty. That is the rapidly changing structure and function of our financial institutions, which raise the question about how home mortgages will be financed in the coming decade. Setting aside the currently existing problems, the question is are we ever going to return to the situation as we knew it where there were institutions devoting themselves solely to providing funds for mortgages and were able to rely upon that source of revenue, those transactions, in order to exist and, indeed, grow.

One thing has become clear—the traditional sources of home mortgage loans, which are savings deposits in thrift institutions, will not be adequate to satisfy the demands of future home buyers. Whenever the issue of adequate investment capital is raised, inevitably eyes turn toward the pension industry, which manages over a half a trillion dollars in retirement funds. Inevitably, suggestions have come from some housing and pension experts that if ERISA or its regulations were eased, we might stimulate substantial new investments in the lagging housing market.

Now that is what this hearing is all about today. We want to hear from experts what they perceive to be needless impediments. If indeed those impediments exist to prudent pension fund investments in home mortgages.

We also want to know what solutions they propose to this problem consistent with the principle that pension funds should be managed in the best interest of their current and future beneficiaries. I don't want anybody to be confused as to how I stand in this matter. I look on pension funds as existing for the benefit of current and future beneficiaries. That's the goal of pension funds.

I would hope each witness would give his thoughts about the extent to which pension funds with their vast pool of capital will or can offer relief to the housing industry. We want to encourage open discussion. By scheduling this hearing, there is no suggestion whatsoever that we would tolerate any mandatory pension fund investments. Some have been worried that we are seeking a set-aside of extra cent from the funds. That's not my objective certainly. And it's not my objective that we tolerate any kind of investments that would undermine the rights and interests of pension beneficiaries, as I said earlier.

All right. The first witness is Mr. Glickman, Deputy Assistant Secretary for Tax Policy from the Department of the Treasury.

Mr. Glickman, we welcome you here. Why don't you proceed?

Mr. GLICKMAN. Thank you, Mr. Chairman.

Senator CHAFEE. Now you have a statement I presume?

Mr. GLICKMAN. Yes, sir.

Senator CHAFEE. Now as I understand it, you are testifying on the bill dealing with the church pensions. And we have some witnesses at the end of this.

Mr. GLICKMAN. That's correct.

Senator CHAFEE. All right. You have got a statement here of some length, and considerable meat, but nonetheless, why don't you summarize, if you would please?

Mr. GLICKMAN. Yes, sir.

Senator CHAFEE. And we will put all these statements in the record.

STATEMENT OF DAVID GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. I am pleased to present the views of the Treasury Department on S. 1910, which would make certain changes to the Internal Revenue Code relating to retirement arrangements under section 403(b), and to certain qualified plan provisions for clergy and lay employees of churches.

While the Treasury Department has some concern with the basic thrust of section 403(b), we are sympathetic to the problems faced by churches in providing adequate retirement benefits to clergy and lay employees. S. 1910 is intended to address these problems. As I will discuss shortly, the Treasury Department will support certain of the provisions of 1910. Others, we think, are too broad, and could permit excessive deferral of income taxes by individuals with high incomes.

As background, I think it would be important to say that section 403(b) permits employees of educational institutions and organizations exempt from tax under section 501(c)(3) of the code to enter into special arrangements with their employers under which retirement benefits are provided. Such arrangements typically provide for salary reductions, although in other cases the retirement benefits are provided solely by employer contributions. Whichever method is used, section 403(b) contains complex rules for determining the maximum amount of the employee's compensation that can be deferred each year. An understanding of these rules is necessary to understand both the reason for the provision and the reasons for our opposition for certain provisions of the bill.

Under the basic rules of section 403(b)(2), the limit on the contributions that may be made on behalf of an employee and excluded from current income, is 20 percent of the employee's compensation includible in gross income received from his employer for the current year, multiplied by the employee's years of service with the employer, less the amounts previously contributed to the plan. This allowance, however, is also subject to the limitations on contributions and benefits contained in section 415, which provide that amounts deferred cannot exceed the lesser of 25 percent of compensation or $45,475 for 1982.

Mr. Chairman, there's an example in my written statement setting forth how the mechanics of this actually work.

The section 415 limits, which I have just mentioned, may severely restrict an individual's ability to make up for low contributions in early years.

Senator CHAFEE. Could I just ask a question? 501(c)(3) institutions, normally, would obviously be a church or educational institution, hospital, charity. What about the Ford Fund, for example?

Mr. GLICKMAN. I believe that the Ford Foundation is a 501(c)(3) organization.

Senator CHAFEE. So this rule would apply to the president of the Ford Foundation?

Mr. GLICKMAN. The rules that exist now apply to educational institutions, hospitals, and home service agencies. But the general rules of 403(b) do apply to all 501(c)(3) organizations. That's correct. So assuming that the Ford Foundation is a 501(c)(3) organization, as I believe it is, it would apply to the president or the chairman of that organization.

Senator CHAFEE. All right.

Mr. GLICKMAN. As I said, the section 415 limits which I discussed could limit the amount that individuals could put away to compensate for his low contribution years under a section 403(b) plan. As a result, when ERISA was enacted in 1974, there were three provisions concerning catchups which would allow employees of educational institutions, hospitals, and home service agencies to make catchup contributions to compensate for their low-income years. It's interesting to note that church employees were not covered at that point in time in the catchup provisions.

Senator CHAFEE. Why weren't they included?

Mr. GLICKMAN. Well, Mr. Chairman, we have looked into that. It is our understanding that there was no policy reason for not including them. They were not included because they were not one of the constituencies represented at that point in time.

Senator CHAFEE. It wasn't based on an antichurch feeling in the Treasury?

Mr. GLICKMAN. That's our understanding.

Senator CHAFEE. It was or wasn't?

Mr. GLICKMAN. It was not.

Senator CHAFEE. It was not. Thank you.

Mr. GLICKMAN. Now the rules of section 403, as I think are obvious, may provide significantly greater benefits than the rules that generally govern tax favored retirement plans. For example, the 403(b) deferrals are not subject to the nondiscrimination rules applicable to other qualified plans. Second, as I pointed out, certain groups may utilize the catch-up rules to avoid the section 415 limitations.

Now, Mr. Chairman, Treasury would generally favor the policies reflected in section 415 of the code which seeks to limit the portion of earnings which can be set aside on a tax deferred basis. We also believe that retirement plans which receive favorable tax treatment should be administered in a nondiscriminatory manner.

Thus, proposed legislation which would expand the special preference for tax exempt institutions embodied in section 403(b) must be scrutinized carefully to assure that it does not expand the scope of section 403(b) and permit additional tax favored treatment for highly compensated individuals or create artificial incentives to establish section 403(b) plans rather than qualified plans.

Our review of S. 1910 was based upon these considerations.

Now I would just like to list the various provisions in S. 1910 with Treasury's position with respect to each one.

First are the catchup rules. The bill would amend sections 403(b)(2)(b) and 415 to extend the catchup rules to church employees who cannot now use the catchup provisions even though they, like teachers and hospital workers, may receive relatively low compensation in their earlier years. Treasury supports extending eligibility for the catchup elections to the church employees.

The next provision deals with determination of years of service. Section 2 of S. 1910 would expand the years of service taken into account in computing the exclusion allowance available to certain church employees under section 403(b)(2). Under current law, the taxpayer may take into account only periods of service with his or her current employer. This may cause different treatment for employees of churches organized on a hierarchical basis as opposed to employees of churches organized on a congregational basis. An employee who transfers from one church to another in a hierarchical structure remains with the same employer, and hence does not lose the credit for past periods of service. An employee who transfers from one church to another in a congregational structure changes employers and loses prior years of service. Under the bill, all periods of service with all churches within one denomination would be considered as periods of service for one employee.

In view of the difficulties which we envision in determining whether the church employee has changed employers, Treasury would support this change.

Next is the concept of minimum includible contribution. Section 3 of the bill would establish a minimum amount of includible contribution for determining the exclusion allowance under section 403(b). The minimum is to be not less than twice the nonfarm income poverty guideline for a family of four residing in the contiguous United States. We have been advised that the nonfarm income poverty guideline for 1982 was $9,300. And, thus, this would set a minimum standard of $18,600. We understand that this proposal is designed to allow adequate retirement contributions to be made for missionaries serving outside the United States, and for low paid clergy. We recognize that there may be problems in this area, especially with regards to missionaries, but we believe that the approach taken in the bill is overly broad for it applies to all persons eligible for the section 403(b) arrangement. It may enable certain individuals to defer an amount in excess of their actual includible compensation, thereby discriminating in favor of those persons with incomes from outside sources. We also believe that the provision will be complex to administer. We, therefore, oppose this provision. However, we would be happy to work with the subcommittee and its staff to determine whether an alternative approach to the problem faced by missionaries and low members of the clergy can be developed.

The next issue is church annuity plan contracts. Section 4 of the bill would provide, in essence, that a church could fund a section 403(b) plan without purchasing a life insurance contract or shares of a regulated investment company. This provision would provide churches with the statutory relief from the position of the Internal Revenue Service that section 403(b) annuity contracts must be purchased from an insurance company or a regulated investment company. This provision was formerly announced in Revenue Ruling 82-102——

Senator CHAFEE. I tell you, Mr. Glickman, this is rather lengthy and technical. Why don't you just summarize. As far as the annuity contract, get down to whether you are for or against it. I think you conclude on this one that you have reservations?

Mr. GLICKMAN. Mr. Chairman, we have no objection to the principle that is set forth in the bill concerning the concept that churches should be able to continue to use diverse investment vehicle approaches. However, we are concerned with the implication of the use of the phrase "annuity contract". And we would suggest that a proposal be adopted which is much more in the nature of 403(b)(7) rather than using the phrase "annuity contract." As you know, this has given us a great deal of trouble in other sections.

Senator CHAFEE. All right. Let's go to constructive receipt.

Mr. GLICKMAN. With respect to the constructive receipt provision, the bill, as you know, would like to remove a specific phrase—"or made available." Treasury has no problem with removing that, provided that the restrictions of section 403(b)(7), which require that the funds cannot be removed until 59½ years or termination of service or illness, be superimposed. With that change, we would accept this provision.

Senator CHAFEE. All right. Just summarize the minimum contribution.

Mr. GLICKMAN. The Treasury would strongly oppose the minimum contribution provision. It would increase substantially the scope of 403(b) plans. In our judgment, it is not a de minimis contribution: and it will apply to more than the clergy. The Treasury does not support this provision.

Senator CHAFEE. All right. Forfeitability.

Mr. GLICKMAN. With respect to the forfeitability provision, this goes to certain types of plans which provide forfeitable benefits and are therefore not originally covered by section 403(b). Subsequently, the forfeitability provisions are vested and the contribution is then deemed to be made to a 403(b) plan. But what the provision would do is waive the limits imposed on plan contributions.

Senator CHAFEE. And you are opposed to that?

Mr. GLICKMAN. We are opposed to that.

Senator CHAFEE. All right. Administrative forbearance.

Mr. GLICKMAN. The church plans would like an extended period to comply with statutory requirements. This is not limited to section 403(b) plans. It addresses a problem which is indigenous to virtually all plans that were covered by ERISA. Many people found it very inconvenient to satisfy the requirements of ERISA, but literally thousands of plans have satisfied the requirements. And, thus, we see no reason why one specific group should be given a special dispensation from these rules. We would strongly oppose this type of approach.

With respect to the effective date issue Treasury feels that this bill should be made effective prospectively only.

Senator CHAFEE. All right. I know both Senator Dole and Senator Bentsen are interested in this legislation. As I get your presentation and concept, you support the bill; you have problems with it in the areas that you point out. I think what we will have to do is have you and your associates work with the staffs of Senator Bentsen, Senator Dole to iron these problems out. And I would appreciate it if you would review the testimony of those who are going to testify in the last panel that we have today, the six clergymen, because obviously this is something that is important to them and something we would like to resolve.

Mr. GLICKMAN. I would be happy to, Mr. Chairman.

Senator CHAFEE. All right. Fine. Thank you very much, Mr. Glickman.

[The prepared statement follows:]

<u>For Release Upon Delivery</u>
Expected at 9:30 A.M. E.D.T.
May 19, 1982

STATEMENT OF
DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY
OF THE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on S. 1910, which would make certain changes in the Internal Revenue Code relating to retirement arrangements under section 403(b), and to qualified plans for clergy and lay employees of churches, conventions or associations of churches, and organizations that are exempt from tax under section 501 and which are controlled by or associated with a church or convention or association of churches.

While the Treasury has some concern with the basic thrust of section 403(b), we are sympathetic to the problems faced by churches in providing adequate retirement benefits to clergy and lay employees. S. 1910 is intended to address these problems. We support aspects of the bill that would create parity between the clergy and employees of educational institutions, hospitals, and home health service agencies. We also support the provisions of S. 1910 that will enable section 403(b) plans maintained by churches to operate in a manner that is consistent with the historical ~~patterns of~~ church organization and funding of such plans. However, we believe that other provisions contained in S. 1910 are overly broad, and may permit excessive deferral of income tax by individuals with high incomes.

Background

Section 403(b) of the Code permits employees of educational institutions and organizations exempt from tax under section 501(c)(3) of the Code to enter into special arrangements with their employers under which retirement benefits are provided. Such arrangements typically provide for salary reductions, although in other cases the retirement benefits are provided solely by employer contributions. Whichever method is used, section 403(b) contains complex rules for determining the maximum amount of an employee's compensation that can be deferred each year. An understanding of these rules is necessary to understand both the reasons for the provisions in S. 1910 and the reasons for our opposition to various aspects of the bill.

Under the basic rule of section 403(b)(2), the contribution that may be made on behalf of an employee and excluded from current income (the exclusion allowance) is 20 percent of the employee's compensation includible in gross income received from his employer for the current year, multiplied by the employee's years of service with the employer, less the amounts previously contributed to a section 403(b) plan. This allowance is, however, also subject to the limitations on contributions and benefits contained in section 415 of the Code. Under section 415, the amount deferred cannot exceed the lesser of 25 percent of compensation or $45,475 for the 1982 plan year.

Let me illustrate this rule with a simple example. Assume that a high school teacher has worked for the same employer for 20 years and has a salary of $20,000 (exclusive of any amounts contributed to a section 403(b) arrangement). His employer previously has made contributions to a section 403(b) arrangement on his behalf of $4,000. The teacher participates in no other plan maintained by his employer. The teacher's exclusion allowance is ~~determined by~~ multiplying 20 percent of his compensation of $20,000 by his 20 years of service, giving a total of $80,000. The resulting amount is then reduced by the employer's prior contribution of $4,000, giving a hypothetical exclusion allowance under section 403(b)(2) of $76,000. However, since contributions to a section 403(b) arrangement are subject to the limitations of section 415, the maximum amount that can be deferred is $5,000, which is 25 percent of the teacher's compensation.

The section 415 limits may severely restrict an individual's ability to make up for low contributions in earlier years to a section 403(b) plan. As a result, when ERISA was enacted in 1974, three separate "catch up" rules were provided in section 415(c)(4) for employees of educational institutions, hospitals, and home health service agencies. Under the catch up rule most likely to be used in the above example, the exclusion allowance is increased to the lesser of three amounts:

1. 25 percent of the employee's includible compensation plus $4,000;
2. the section 403(b)(2) exclusion allowance; or
3. $15,000.

In the example, the relevant figures are $9,000; $76,000; and $15,000 respectively. Thus, the employer can contribute $9,000. This is a substantial deferral of income -- close to 40 percent of the teacher's salary.

The rules of section 403(b) may provide significantly greater benefits than the rules that generally govern tax-favored retirement plans. First, section 403(b) deferrals are not subject to the nondiscrimination rules applicable to qualified plans. Second, groups that utilize the catch up rules are also able to avoid, to a limited extent, the limits on contributions and benefits imposed by section 415.

We generally favor the policy reflected in section 415 of the Code, which seeks to limit the portion of earnings which can be set aside on a tax-deferred basis. We also believe that retirement plans which receive favorable tax treatment should be administered in a nondiscriminatory manner. Thus, proposed legislation that would expand the special preference for tax-exempt institutions embodied in section 403(b) must be scrutinized carefully to ensure that it does not expand the scope of section 403(b), permit additional tax-favored treatment for highly compensated individuals, or create artificial incentives to establish section 403(b) plans rather than qualified plans. Our review of S. 1910 has been based on these considerations.

Analysis of S. 1910

Catch-up Rules

The bill would amend sections 403(b)(2)(B) and 415(c)(4) to extend the catch-up rules to church employees, who cannot now use the catch up provisions even though they, like teachers and hospital workers, may receive relatively low compensation in their early years of employment. Treasury supports extending eligibility for catch up elections to church employees under the existing rules of section 415(c)(4).

Determination of Years of Service

Section 2 of S. 1910 would expand the years of service taken into account in computing the exclusion allowance available to certain church employees under section 403(b)(2). Under current law, a taxpayer may take into account only periods of service with his or her current employer. This may cause different treatment for employees of churches organized on a hierarchical basis as opposed to employees of churches organized to a congregational basis. An employee who transfers from one church to another in a hierarchical structure remains with the same employer and, hence, does not lose credit for past periods of service. An employee who transfers from one church to another in a congregational structure changes employers and loses prior service credit.

Under the bill, all periods of service with all churches within one denomination would be considered as periods of service for one employer. In view of the possible difficulty of determining whether the church employee has changed employers, Treasury supports this change.

Minimum Includible Compensation

Section 3 of the bill would establish a minimum amount of includible compensation for determining the exclusion allowance under section 403(b)(3). This minimum is to be not less than twice the nonfarm income poverty guideline for a family of 4 residing in the contiguous United States. The level is to be determined under regulations prescribed by the Secretary and is to be revised in the same manner as the Office of Management and Budget's procedures for establishing poverty guidelines.

We understand that this proposal is designed to allow adequate retirement contributions to be made for missionaries serving outside the United States and for low paid clergy. We recognize that there may be problems in this area, especially with regard to missionaries, but we believe that the approach taken by the bill is overly broad, for it applies to all persons eligible for a section 403(b) arrangement. It may enable some individuals to defer an amount in excess of their actual includible compensation, thereby discriminating in favor of those persons with income from outside sources. We also believe the provision will be complex to administer. We therefore oppose this provision. However, we would be happy to work with this Subcommittee and its staff to determine whether alternative approaches to the problems faced by missionaries and low paid members of the clergy can be developed.

Church Plan Annuity Contracts

Section 4 of the bill would provide, in essence, that a church could fund a section 403(b) plan without purchasing a life insurance contract or shares of a regulated investment company. This provision would provide churches with statutory relief from the position of the Internal Revenue Service that section 403(b) annuity contracts must be purchased from an insurance company or a regulated investment company. This position was formally announced in Revenue Ruling 82-102, which was published in the May 17, 1982 Internal Revenue Bulletin. That ruling is not directed at any abuse of section 403(b) arrangements by church plans. Its sole purpose is to preclude recharacterization of savings accounts and other investments as annuity contracts.

We recognize that many churches historically have funded their section 403(b) plans through diverse investment vehicles, and we have no objection in principle to the continuation of this practice. Indeed, Revenue Ruling 82-102 grandfathers existing section 403(b) plans that use alternative investment vehicles.

However, while we generally agree with the concept of section 4 of the bill, we are concerned with the implications of the use of the term "annuity contract". This is a term that is used in the Internal Revenue Code in connection with both tax-favored retirement plans, including section 403(b) arrangements, and nonqualified arrangements. In recent years, the Internal Revenue Service has experienced serious administrative problems in distinguishing between "annuity contracts", which are subject to favorable tax treatment, and investments such as savings accounts and money market funds. The use of the term "annuity contract" in the bill could have substantial implications outside the context of section 403(b). This section should be revised to clarify that the bill is not designed to broaden the traditional meaning of the term "annuity contract." With such revision, we support this section of the bill.

Constructive Receipt

Section 5 of S. 1910 would eliminate the phrase "or made available" from section 403(c) of the Code. This would parallel amendments to section 402(a) dealing with taxation of distributions from qualified plans made by the Economic Recovery Tax Act of 1981. This change, like the change in section 402(a), would enable section 403(b) programs to be designed and administered more efficiently.

We do believe, however, that the restrictions on distributions contained in section 403(b)(7) should be applied to all section 403(b) plans. This will ensure that section 403(b) plans are in fact used for retirement, rather than as a tax-favored vehicle for short-term savings. With this change, we support this section of the bill.

Minimum Contributions

The bill would amend section 415(c) to permit those persons eligible to use the catch up rules to exclude a *de minimis* contribution of $10,000, subject to the general exclusion allowance rules. The $10,000 *de minimis* contribution would be indexed for cost of living increases since 1974. Thus, the *de minimis* rule would allow exclusion of a contribution of $18,190 in 1982.

We do not believe a contribution of this magnitude can be deemed *de minimis*. The minimum contribution is not limited in scope to members of the clergy, but is also available to teachers, and other employees of schools, hospitals, and home health service agencies. The minimum contribution rule dramatically expands the deferral possibilities available to these groups under section 403(b). For example, the teacher in the example set forth previously could exclude close to 100 percent of compensation in 1982 under this rule. This is more than twice the deferral possible under the catch up rule. Such deferral possibilities would increase with any future increases in the cost of living.

For these reasons, Treasury opposes the *de minimis* contribution rule.

Forfeitability

Section 403(b) annuity contributions must be nonforfeitable. However, a common historical practice has been to provide forfeitable annuities until employees have completed a stated number of years of service. Such forfeitable annuities are not includible in the employee's income under section 83. When the employee completes the required period of service, the annuity is transferred to a section 403(b) arrangement. Under section 403(b)(6), the value of such annuity is treated as an employer contribution in the year nonforfeitability occurs. Hence, the amount is subject to the section 403(b) exclusion allowance rules in that year. As noted previously, the exclusion allowance may exceed the contribution permitted under section 415.

Section 8 of the bill would enable section 415 to be avoided by treating forfeitable employer contributions as annual additions under section 415 in the year in which the contribution is made, rather than in the year in which the contribution becomes nonforfeitable. The proposed change would require contributions which become nonforfeitable to be treated differently for purposes of section 403(b) and 415. We believe this change would cause undue complexity. Further, it would encourage delayed vesting and would conflict with the underlying purpose of the bill, which is to increase retirement income security of church employees. We therefore oppose this section of the bill.

Administrative Forbearance

The final section of the bill does not deal with section 403(b). It provides church plans with an extended period in which to comply with statutory requirements for qualification under section 401(a) of the Code.

Under current law, any plan that fails to meet the qualification requirements of section 401(a) due to a change in the statute or due to a plan amendment, may correct the defect up to the due date (including extensions) of the employer's return for the year in which the defect arose. The period is extended for 91 days after the Service mails a notice of default or the Tax Court issues a final decision on an action for declaratory judgment on the plan's qualified status. Extensions of this remedial amendment period may be granted under section 1.401(b)-1(e) of the current Treasury regulations.

Section 10 of the bill would extend the period in which a church plan must correct a failure to meet section 401(a) qualification requirements for at least 2 years after enactment of this bill. The period would be further extended if a plan defect were discovered on audit. Hence, if this bill were passed today, a church plan could not be required to comply with the qualification requirements of ERISA and subsequent legislation until May 19, 1984. That date would be almost 10 years after the enactment of ERISA, over eight years after most of the new qualification requirements imposed by ERISA became effective, and almost five years after expiration of the Service's special extended remedial amendment period for complying with final tax regulations under ERISA.

This provision is said to be necessary because of the difficulty church plans face in making timely plan amendments. However, although many plan sponsors found it difficult or inconvenient to comply with qualification requirements in a timely fashion, they have amended their plans. We see no reason why one group should receive special statutory dispensation from the rules with which so many plan sponsors have complied. Further, extensions of the remedial amendment period may be granted in meritorious cases under current Treasury Regulations. Thus, we believe that a blanket statutory exception, which would permit automatic delay in meeting plan qualification requirements for all church plans, is unnecessary. We strongly oppose this provision.

<u>Effective Dates</u>

The provisions of the bill would generally be effective for taxable years beginning after December 31, 1980. However, years of service prior to January 1, 1981, could be aggregated in determining an employee's exclusion allowance for taxable years beginning after December 31, 1980. The provision relating to permissible investments and nonforfeitability generally would be effective for all taxable years, including years prior to January 1, 1981.

The Treasury generally opposes retroactive effective dates. Thus, we believe that the provisions of the bill should be applied prospectively.

I will be happy to answer any questions you may have.

Senator CHAFEE. Mr. Clayton. He is the Administrator of pensions and welfare benefit programs. Now we will go back onto the ERISA and what might be done in connection with pension plans as regards the housing industry.

We welcome you, Mr. Clayton. Why don't you proceed.

STATEMENT OF JEFFREY CLAYTON, ADMINISTRATOR, PENSIONS AND WELFARE BENEFIT PROGRAMS, U.S. DEPARTMENT OF LABOR

Mr. CLAYTON. Thank you, Mr. Chairman.

Senator CHAFEE. Now, again, so many witnesses come and we tell them to abbreviate their statements and they say they certainly will. And then they proceed to read verbatim from their statements. You will just have to summarize. You have 5 minutes.

Mr. CLAYTON. Thank you. I am happy to appear before you today to discuss the Department of Labor's——

Senator CHAFEE. We will give you a little more time because you are really dealing with the guts of the whole matter we are wrestling with here today. You go ahead. You are not going to be cut off. [Laughter.]

Mr. CLAYTON. Thank you. I am happy to be here today. As you are aware, the Department, in conjunction with the President's Commission on Housing and the Cabinet Ad Hoc Working Committee on Housing, identified several steps that could be taken to make it easier for pension plans to invest in housing. We hope that these steps, along with other actions recommended by the President, will aid the residential housing industry.

We recognize this is an important area. There are critical problems in the housing industry. And there is an important role for pension fund investments in the housing industry.

I'll discuss later some of the things—the technical things—we have done to remove some of the barriers, the technical barriers at least, which may have impeded the flow of pension investments into residential housing.

ERISA requires, among other things, that fiduciaries of employee benefit plans discharge their duties solely in the interest of the plan's participants and beneficiaries, for the exclusive purpose of providing benefits to participants and beneficiaries, and with the care, skill, prudence, and diligence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.

We issued regulations basically setting forth the Department's position with respect to that prudent standard. We have consistently taken the position that it is not our role to encourage or discourage any specific type of investment. We believe that the market place should determine how assets are invested. By requiring fiduciaries to invest prudently, we provide complete freedom for the market to direct plan investments.

While there is flexibility in selecting investments under prudence generally, there is no flexibility in the law regarding the objectives sought in making these prudent investments under the traditional duty of loyalty concepts as embodied in ERISA. These provisions obligate a plan fiduciary to manage plan assets for the exclusive benefit of plan participants and solely in their interests. The Department does not have the authority to grant exemptions from these statutory requirements.

Since in determining what is prudent, ERISA prohibits plan fiduciaries from acting other than for the exclusive purpose of providing benefits to participants and beneficiaries, the fiduciary who undertakes social investing, that is, who takes into consideration objectives other than providing retirement income, at the expense of economic return to the fund, will be violating ERISA. The phrase "social investing" is generally used as a kind of shorthand for the concept that a plan might be willing to sacrifice a certain amount of investment yield if the investments were to further some otherwise desired objective.

Under current law, primary examples of illegal social investing are where private pension plans make below market interest rate loans for housing in order to help the housing industry or where private pension plans provide construction or mortgage financing conditioned on the work being done by union contractors, or where the pension funds are used by corporations to fend off an unwanted takeover bid. We recognize the legitimate needs of the housing industry for investment—and certainly pension plans are a huge potential source of capital—but that investment cannot be subsidized by the private pension plans. Nor can the plans be used as a private source of capital. The pension fund is not for the use of the employer, nor is it for the use of the union. The pension fund is to be used exclusively for the purpose of providing benefits to all the participants and beneficiaries.

The argument has been made that social investment by the construction industry plans in housing is defensible on the grounds that it provides jobs to workers, which in turn keeps contributions flowing to the plan. While on the surface this argument is appealing, one should realize that the financial gain to a plan which employed such a strategy would be almost entirely without substance, since dollars that come into the plan are contributed to pay for benefits promised to employees who have earned them. In the final analysis, adding more employees may not help a plan which is underfunded because while it may increase payments into the plan, it will also increase the benefit liability of the plan. In addition, such an argument leads to some troublesome conclusions. For example, using pension money to support union organizing campaigns aimed at broadening the contribution base for plans might then be thought justified as legitimate plan expenditures.

Advocates of the social approach to housing investments have also argued that even where the yield to plans is less than what could be otherwise achieved, plans may still be performing better in housing than with other types of investment or performing better than actuarial projections. To permit a plan to deliberately accept a lower yield than the marketplace would really produce, adopts social concerns and/or self-interest as the ERISA investment criteria. This is not only unacceptable under ERISA principles, but it is contrary to commonsense. Would a prudent person sell an asset for less than its fair market value because his other investments produced a smaller yield or because he only needed a smaller amount of money at the time?

Despite what I just said about social factors, there is one way plans can consciously elect to invest funds in housing for social reasons. Assuming there are no diversification problems and there are a number of investment opportunities of equal prudence, ERISA does not prevent a selection among opportunities based on other incidental factors, such as a desire to aid housing. This position permits a certain flexibility for socially sensitive investments once the range of available investments has passed the financial considerations test, but not before.

The Department does not have the authority to provide exceptions to the prudence standard. Even if we had the authority, we would not want to do so. ERISA also, however, adds another layer of protection. This is the prohibited transaction provisions. In cases where we can find, among other things, that it is in the interest of and protective of, participants and beneficiaries, we can issue exemptions from these prohibitions. We have found that in the housing area there are many transactions which are technically prohibited which pose no danger to plan participants and beneficiaries. Accordingly, we have issued two class exemptions that will make it easier for plans to engage in prudent housing investments. In addition, we have issued a regulation making clear that the underlying mortgages in certain governmental mortgage pools are not plan assets. We are hopeful that these actions will assist those pension plans which wish to invest in housing.

Senator CHAFEE. You have just issued these regulations. Is that right?

Mr. CLAYTON. Right. They were published in the Federal Register yesterday.

Senator CHAFEE. Now does that cover the two class exemptions that you were talking about?

Mr. CLAYTON. Yes. The residential mortgage class exemption and the amendment to 81-7, the existing class exemption, plus the small portion of the plan asset regulation that deals with Ginnie Maes, Fannie Maes, and those kind of mortgage backed securities——

Senator CHAFEE. Those just went out yesterday?

Mr. CLAYTON. Yes.

In addition to the class exemptions, we also issued the portion of the plan assets regulation which basically makes clear that Fannie Mae, Ginnie Mae, and Freddy Mac mortgage passthrough certificates or mortgage-backed certificates are not plan assets. Thus, making it easier for pension plans to pick them up.

To the extent that ERISA's technical barriers have discouraged plans from considering housing investments, our actions in removing these barriers should help. Our actions should not, as I stated earlier, be read to mean that we will tolerate any weakening of the prudence standard or to be the advocacy on the part of one type of investment in housing over others. The Department's view is that the prudence standard is a neutral one in which investments are made solely in response to market forces to maximize income for the plan.

It is important to note that collectively the funds invested in pension plans represent a substantial portion of all the long-term capital in our economy. Only by letting the market system allocate funds among competing users can our capital markets continue to operate effectively and efficiently so as to provide the strongest possible economy.

ERISA already has a social purpose. That purpose is to assure that funds are available to pay the anticipated retirement and other benefits of plan participants and beneficiaries. We will strongly enforce the prudence and the exclusive benefit rule to assure that this purpose is carried out. Our Nation's retirement system is too important and has too many financial problems of its own to expect it to subsidize special investments which cannot stand on their own merits.

I'd be happy to answer any questions that you might have.

[The prepared statement follows:]

STATMENT OF JEFFREY N. CLAYTON
ADMINISTRATOR
PENSION AND WELFARE BENEFIT PROGRAMS
BEFORE THE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY
COMMITTEE ON FINANCE
UNITED STATES SENATE

May 19, 1982

Mr. Chairman and Members of the Subcommittee:

I am happy to appear before you today to discuss the Department of Labor's views on private pension fund investments in the home mortgage market. It is an area to which we have given a great deal of thought and attention.

As you are aware, the Department, in conjunction with the President's Commission on Housing and the Cabinet Ad Hoc Working Committee on Housing, identified several steps that could be taken to make it easier for pension plans to invest in housing. We are hopeful that these steps, along with other actions recommended by the President, will aid the residential housing industry.

The Department recognizes the critical problems in the housing area and the important role pension fund investment in housing can play. To the extent that such investments are consistent with the fiduciary requirements of the Employee Retirement Income Security Act (ERISA), we intend to do all we can to remove technical barriers to plan investment. Accordingly, we have taken several steps, which I will discuss in detail later, to remove technical barriers ERISA may impose to the flow of pension investments into residential housing. These technical barriers, however, are basically in the area of prohibited transactions; they are not in the basic protections that "prudence" offers plan participants and beneficiaries, nor do they change the "exclusive benefit" rule.

ERISA requires, among other things, that fiduciaries of employee benefit plans discharge their duties solely in the interest of the plan's participants and beneficiaries, for the exclusive purpose of providing benefits to participants and beneficiaries, and with the "care, skill, prudence, and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." In addition, investments must be diversified.

In 1979, the Department issued regulations interpreting the prudence standard. In those regulations, the Department focused on the procedure used in determining whether or not to make the investment rather than on the results of the investment. Thus, there are no per se prudent or imprudent investments, rather, the fiduciary must look at the merits of each investment and consider whether, based on the plan's portfolio and needs, the investment provides the greatest return consistent with the financial risk.

We have consistently taken the position that it is not our role to encourage or discourage any specific type of investment. We believe that the marketplace should determine how plan assets are invested. By requiring fiduciaries to invest prudently, we provide complete freedom for the market to direct plan investments.

While there is flexibility in selecting investments under prudence generally, there is no flexibility in the law regarding the objectives sought in making these prudent investments under the traditional duty-of-loyalty concepts as embodied in ERISA. These provisions obligate a plan fiduciary to manage plan assets for the exclusive benefit of plan participants and solely in their interests. The Department does not have the authority to grant exemptions from these statutory requirements.

Since in determining what is prudent, ERISA prohibits plan fiduciaries from acting other than for the exclusive purpose of providing benefits to participants and beneficiaries, the fiduciary who undertakes "social investing," that is, who takes into consideration objectives other than providing retirement income, at the expense of economic return to the fund, will be violating ERISA. The phrase "social investing" is generally used as a kind of shorthand for the concept that a plan might be willing to sacrifice a certain amount of investment yield if the investments were to further some otherwise desired objective.

Under current law, primary examples of illegal "social investing" are where private pension plans make below market interest rate loans for housing in order to help the housing industry or where private pensions plans provide construction or mortgage-financing conditioned on the work being done by union contractors, or where pension funds are used by corporations to fend off an unwanted takeover bid. We recognize the legitmate needs of the housing industry for investment, and certainly pension plans are a huge potential source of capital. But that investment cannot be subsidized by a private pension plan; nor can the plans be used as a private source of capital. The pension fund is not for the use of the employer, nor is it for the use of the union. The pension fund is to be used exclusively for the purpose of providing benefits to all the participants and beneficiaries.

In addition, once other factors are introduced, prudence becomes impossible to enforce since there would be no objective standards. In such a case, the free market no longer is allowed to be the efficient allocator of pension resources. Instead each fiduciary's personal judgment of what is "socially" desirable would become the shifting standard.

The argument has been made that "social investment" in housing by construction industry plans is defensible on the grounds it provides jobs to workers which in turn keep contributions flowing into the plan. While on the surface this argument is appealing, one should realize that the financial gain to a plan which employed such a strategy would be almost entirely without substance, since dollars that come into a plan are contributed to pay for benefits promised to employees who have earned them. In the final analysis, adding more employees may not help a plan which is underfunded, because while it may increase payments into the plan it will also increase the benefit liability of the plan. In addition, such an argument leads to some troublesome conclusions. For example, using pension money to support union organizing campaigns aimed at broadening the contribution base for plans might then be thought justified as legitimate plan expenditures.

Advocates of a "social" approach to housing investments have also argued that even where the yield to plans is less than what could be otherwise achieved, plans may still be performing better in housing than with other types of investment or performing better than actuarial projections. To permit a plan to deliberately accept a lower yield than the marketplace would produce really adopts social concerns and/or self-interest, as the ERISA investment criteria. This is not only unacceptable under ERISA principles but is contrary to common sense. Would a prudent person sell an asset for less than its fair market value because his other investments produced a smaller yield or because he only needed a smaller amount of money at the time?

Despite what I just said about "social" factors, there is one way plans can consciously elect to invest funds in housing for "social" reasons. Assuming there are no diversification problems and there are a number of investment opportunities of equal prudence, ERISA does not prevent a selection among opportunities based on other incidental factors, such as a desire to aid housing. This position permits a certain flexibility for socially sensitive investments once the range of available investments has each passed the financial considerations test, but not before.

The Department does not have authority to provide exceptions to the prudence standard. Even if we did have the authority, we would not want to do so. ERISA also, however, adds another layer of protection. This is the prohibited transaction provisions. In cases where we can find, among other things, that it is in the interest of, and protective of, participants and beneficiaries, we can issue exemptions from these prohibitions. We have found that in the housing area there are many transactions which are technically prohibited but pose no danger to plan participants and beneficiaries. Accordingly, we have issued two class exemptions that will make it much easier for plans to engage in prudent housing investments. In addition, we have issued a regulation making clear that the underlying mortgages in certain governmental mortgage pools are not plan assets. We are hopeful that these actions will assist those pension plans which wish to invest in housing.

We proposed a class exemption for transactions involving certain residential mortgage financing arrangements last December. The final exemption is considerably broader than the proposed exemption. The final exemption permits plans, subject to specific conditions, to directly, and through commitments, make mortgage loans on most types of residential dwelling units without violating certain of ERISA's prohibited transaction rules. Plans also will be permitted to receive fees for the issuing of commitments and to make or purchase mortgage loans or participating interests in such loans on over the counter or direct purchase transactions.

The other class exemption is a proposed amendment to Prohibited Transaction Exemption (PTE) 81-7. Currently, PTE 81-7 provides relief from ERISA's prohibited transaction provisions for the purchase by employee benefit plans of certificates issued by mortgage pool investment trusts when the pool sponsors, trustees or insurers are parties in interest to the plan. The exemption presently applies to mortgage pools consisting of interest-bearing obligations secured by first mortgages or deeds of trust on single-family residential property. The Department's proposed revision of PTE 81-7 would extend exemptive relief to: (1) pools of loans secured by second mortgages and second deeds to trust; and (2) forward delivery commitments by plans to accept pool certificates delivered at a specific future date.

In addition to these class exemptions, we just issued in final form the part of the plan assets regulation that relates to governmental mortgage pools. As you are aware, the fiduciary responsibility provisions of ERISA are applicable to those who manage plan assets; but, for the most part, ERISA does not define which assets are plan assets. We have been struggling for some time with a regulation that would define the term "plan asset" in an understandable and practical manner. We are still working on that regulation; however, we have isolated certain issues that affect the housing market and have issued a final regulation on them. In general, the final regulation will make it clear that plan assets include the mortgage pool certificates issued by such entities as GNMA, FNMA, and the FHLMC, but not mortgages underlying the certificates.

To the extent that ERISA's technical barriers have discouraged plan's from considering housing investments, our actions in removing these barriers should help. Our actions should not, as I stated earlier, be read to mean that we will tolerate any weakening of the prudence standard or to be the advocacy on our part of one type of investment--in housing--over others. The Department's view is that the prudence standard is a neutral one in which invest ments are made soley in response to market forces to maximize income for the plan.

It is important to note that, collectively, the funds invested in pension plans represent a substantial portion of all the long term capital in our economy. Only by letting the market system allocate funds among competing users can our capital markets continue to operate effectively and efficiently so as to provide the strongest possible economy.

ERISA already has a "social" purpose. That purpose is to assure that funds are available to pay the anticipated retirement and other benefits of plan participants and beneficiaries. We will strongly enforce the prudence and the exclusive benefit rule to assure that this purpose is carried out. Our Nation's retirement system is too important and has too many financial problems of its own to expect it to subsidize special investments which cannot stand on their own merits.

I would be happy to answer any questions you may have.

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Senator CHAFEE. Thank you very much, Mr. Clayton. I notice our distinguished chairman is here, Senator Dole. Mr. Glickman just testified and he addressed the bill that you and Senator Bentsen have in dealing with clergymen coming into and setting up pension plans. And he said he would be glad to work with your people on trying to work something out. In essence, he supports what you are driving at but he has some problems with some certain specifics.

Senator DOLE. I would just like to put a statement in the record, Senator Chafee. I won't be able to stay for the whole hearing. Not only with reference to S. 1910, but in the interest of what the balance of the hearing is on—over mortgage investment by pension funds. I would ask that my statement be made a part of the record.

Senator CHAFEE. Do you have any questions of Mr. Clayton, Senator?

Senator DOLE. No questions.

Senator CHAFEE. All right, Mr. Clayton, let me read you part of a letter from Mr. Roy Williams, president of the Teamsters, to President Reagan. It's dated April 15, 1982. He says the following:

> I'm suggesting, Mr. President, that the administration propose and support whatever changes are necessary in ERISA and in other federal laws and regulations to allow union pension fund trustees to lend money for home mortgages at below market rates, but above the rates necessary to meet the funds long-term actuarial projections without incurring a fiduciary breach.

Now I think you addressed that in your statement, but why don't you specifically do it now? Please.

Mr. CLAYTON. I think it's notable that Mr. Williams' letter recognizes that that approach would require an amendment to ERISA, a statutory amendment. It isn't allowable under current law. And the Department of Labor has no authority to allow that to happen. I'm not an expert economist, but in my own opinion, one fallacy in that line of reasoning is that allowing a return equal to your actuarial projections means you don't grant any past service credits or retroactive benefit increases. To the extent you grant retroactive benefit increases, which every pension fund I am aware of does, then you are going to undermine your ability to pay those retroactive benefit increases if you are artificially lowering your yield on your investments. That particular system would only work if you never granted any retroactive benefit increases, which doesn't exist in any pension fund that I know of.

However, I am aware that I'm speaking for myself, and I am aware that Mr. Williams' letter is receiving very important consideration by the administration and no decision has been made as to a position on legislation.

Senator CHAFEE. All right. What do you think the off chances are that these new class exemptions that you have just put out will prompt more pension investment in mortgages?

Mr. CLAYTON. Again, I am not an economist so I can't testify as an expert. I have spoken with a lot of pension managers in the last month; particularly, managers of the large pension funds around the country. And I think these steps, candidly, can be characterized as greasing the skids once interest rates come down. I think essentially right now the problem is a market one—that of interest rates. And I think once interest rates begin to fall, once the administration's economic program takes effect, the class exemptions, the regulations that we have just issued will substantially aid the flow of money to housing. But until a market change occurs, I'm not sure what effect they will have.

Senator CHAFEE. You and I both appeared before a pension managers group last week; Thursday and Friday. And it seems to me what they were saying in connection with these suggestions was that they will seek out the best long-term investments for the benefit of their funds. And if mortgages can become attractive enough, they will go into them. But currently mortgages just plain aren't attractive enough. Is that about what you got from their statements?

Mr. CLAYTON. That's pretty much what I understood. And my discussion with them basically indicated that some marketing techniques certainly would help. Pension fund managers are looking for uniformity. They are looking at the predictability of yield and so forth. And the development of packaging mortgages differently, particularly through mortgage backed securities and adopting some new plans in that area, seem to me to provide the most hope for making mortgage investments attractive to pension funds.

Senator CHAFEE. Well, there's no question that the problem with the packaging of the mortgages so that they would be attractive to pensions was one that was raised. And it seems to me that with all the ingenuity that obviously exists out there in the financial community, and it certainly has been demonstrated over the past couple of years—why haven't they gotten around to packaging these mortgages so that they are attractive?

Mr. CLAYTON. I think there has been such a fundamental change in the industry and as a result, new types of mortgage instruments have been popping up over the last few years that are considerably different than second mortgages, variable rate mortgages, balloon mortgages, all the various types. And as a result, on the secondary market in some ways it has had kind of a counter productive effect. That is, they now are only used to dealing with the simple fixed 30-year fixed rate mortgage. They haven't developed the expertise in handling these new kinds; however, I think it is just a question of time. I think really what the housing industry needs to do, in my personal opinion, is to work with pension funds to put together packages that are attractive for pension funds to buy.

I talked to the National Association of Home Builders and they have a committee that has been working on exactly that—uniformity of instruments and so forth. I think there just hasn't been sufficient time for the secondary market to kind of coalesce. It's a very conservative market that has changed slowly over the years.

Senator CHAFEE. Well, their financing is pretty nimble so I think something will come up.

Thank you very much, Mr. Clayton. We appreciate your testimony.

Mr. Georgine. We welcome you, Mr. Georgine. You are a veteran witness here. You have with you some gentlemen?

STATEMENT OF ROBERT GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS, WASHINGTON, D.C.

Mr. GEORGINE. Our legislative rep, Jack Curran. And our general counsel, Tim Smith.

Senator CHAFEE. All right. Why don't you proceed, Mr. Georgine?

Mr. GEORGINE. Mr. Chairman, thank you very much. I am here representing the National Coordinating Committee for Multiemployer Plans. And I won't describe that in detail other than to say that these plans represent the needle trades, the building trades, the maritime trades, and most of the multiemployer plans in the country.

Because of the frequent job changes in the industry in which these plans exist—a multiemployer plan, that is—a plan which provides an employee with credit for service with one or more employers is often the sole means of assuring that these workers receive a pension. Mr. Chairman, the overriding responsibility of the multiemployer plans is to assure that they are administered and maintained in the sole interest of their participants and beneficiaries.

Under the law, this is a concept which has many meanings. But when all is said and done it means that those workers who have agreed to defer a part of their current income today will have some modicum of economic security when they retire.

Workers have the right to expect to collect a pension which they have bargained for and which they have earned. This is a responsibility which we take very seriously. And it's for that reason that the coordinating committee has consistently and vigorously supported the investment of pension funds in residential home mortgages.

Pension plan trustees must take a variety of factors into account in administering a plan. To be sure they must meet the minimum investing, eligibility, benefit accrual, and reporting requirements of the law. And they must see to it that required contributions are paid and that the plan is adequately funded. The enactment of ERISA represented a giant step forward in establishing these most basic of national labor standards. But it is shortsighted to assume that those standards have any real meaning unless the financial assets of pension plans produce a reasonable investment return which will assure the payment of promised benefits, and unless the base of fund contributions—the very source of a plan's assets—remain stable and growing.

The use of pension assets to help finance residential home mortgages is an example of the kind of investment opportunity which serves both of these critical plan objectives.

In addition, it is the type of investment which will help stimulate our national economy and provide a chance for individuals and families to participate in the American dream of owning their own home.

I must say, Mr. Chairman, that I'm sometimes surprised to find that there are those who consider pension investment in home mortgages to be a brand new idea. As a matter of fact, both private and public pension funds have been making their assets available for mortgages for years. Indeed, when I first started out in Chicago our pension funds were already making mortgage investments. On a larger and more formal basis, as early as 1959, the Hawaii Employee's Retirement System initiated a program providing mortgage loans for its participants at 1 to 2½ percent below so-called prevailing rates.

To date that program constitutes $400 million of the plan's $1.45 billion in investments, and there has not been a foreclosure on a single mortgage.

Today, State retirement systems in North Carolina, Massachusetts, Texas, Connecticut, Michigan, New York, and New Hampshire have instituted mortgage loan programs for their participants and other residents of their States. Further, California, Ohio, and Minneapolis, St. Paul are also in the process of establishing mortgage loan investment programs financed in whole or in part by their State or local employee pension plans. Private pension plans have also been at the cutting edge of home mortgage financing for a number of years. To date, the AFL–CIO Mortgage Investment Trust I has completed FHA project loans exceeding $300 million in commitments on 131 projects providing more than 13,000 housing units.

In southern California, a consortium of multiemployer plans has already invested a portion of nearly $115 million in residential mortgages. And local pension trusts in northern California, Washington State, Milwaukee, and south Florida have also instituted home mortgage investment programs.

I venture to say that there would be many more examples of pension fund investment in home mortgage market if it were not for some of the potential impediments of ERISA's fiduciary responsibility and prohibited transactions provisions. I characterize these as "potential" impediments because of my belief that ERISA can and should be flexible enough to permit this important investment opportunity while at the same time providing adequate protection against possible abuse.

I'm proud to say that the coordinating committee has been at the forefront of successfully advocating interpretations of the statute which have begun to breakdown the barriers to pension plan mortgage investments. As you know, Mr. Chairman, certain specific transactions between a plan and a party of interest are absolutely prescribed by the prohibitive transaction provisions of ERISA unless statutorily or administratively exempted.

The statutory exemptions provide only limited relief with respect to mortgage loans to participants and beneficiaries, and in permitting certain parties in interest to provide loan services to the plan.

The most important kinds of relief necessary for successful mortgage investment programs must be obtained through administrative exemptions which are within the discretion of the Department of Labor. During 1976, the coordinating committee requested and was granted a class exemption allowing multiemployer plans to provide construction financing for projects using construction contractors who contributed to such plans. This exemption was applicable to residential and nonresidential construction, and was an important first step toward the objective of opening the door to mortgage loans. In ensuing years, various multiemployer plans were able to secure individual exemptions permitting them to finance the purchase of industrial and commercial buildings and single family homes which were constructed by employers contributing to those plans.

Unfortunately, these individual exemptions tend to become bogged down in the bureaucratic process of the Department of Labor. They've taken too long a period to be approved. And, thus, with the escalating cost of money, the very projects for which mortgage financing was intended have been put at risk. In view of the growing number of problems with the individual exemption approach, the coordinating committee decided that the multiemployer plans needed a more certain relief from the prohibited transaction provisions if there was going to be any real opportunity to pursue and increase investments in home mortgages.

So in 1980 we filed an application for a class exemption for transactions related to long-term residential mortgages that involved collectively bargained plans and certain parties in interests, such as mortgage bankers, developers, and builders, and individuals who are employees of a contributing employer, service provider or union. The coordinating committee was pleased that the Labor Department finally issued this exemption last week—2 years later. Although it is not responsive to all our concerns, we hope that that final class exemption will not only help in the homebuilding industry, but provide job opportunities in construction and related industries. And thereby increase the pool of plan contributions and plan assets.

Moreover, it will make its most attractive form of investment opportunity more readily available to our multiemployer plans. But ERISA's prohibited transaction rules are not the only obstacle to plan investments in the home mortgage market. Under the law, plan trustees are required to act prudently and for the exclusive benefit of the plan's participants and beneficiaries. As a union official, as a former plan trustee, as chairman of the National Coordinating Committee for Multiemployer Plans, and as a responsible citizen, I fully support this most basic of fiduciary standards.

In June 1979 the Labor Department published a regulation governing the concept of prudence, which made eminent good sense at that time as that term is applied to the plan investments under ERISA. That rule effectively states that a plan fiduciary must not rely solely on one factor in considering how to invest plan assets, but rather must consider the entire portfolio in formulating the plan's investment program.

The problem which has developed is that the Labor Department has taken public positions which appear to stray from its prudence rule. In early 1980 as the debate on so-called social investing swept the country, the former administrator of the Labor Department's ERISA program began suggesting that the rate of return must be the paramount, if not the exclusive, concern of the trustees, and that any trustees who took other factors into account were running serious risks of enforcement action by the Department.

Although he acknowledged that under certain circumstances other factors should be considered, the entire thrust of the Labor Department's public statements was to put a chill on mortgage programs which were already underway.

As you recall, Mr. Chairman, interest rates 3 years ago started reaching levels which made it impossible for workers to afford a home. In the first place, the cost of money significantly increased the cost of construction. Secondly, the cost of borrowing to the purchaser made it prohibitive if, indeed, the purchaser could even qualify. In these circumstances, many plans began to consider making mortgages available, especially to their own participants, at rates below the artificially high rates posted by local banks. Officials of the Labor Department immediately began making public statements casting doubts on the legality of these so-called below market mortgages. In order to clarify this potential problem and to resolve the question of the interest rates which a plan could charge on a participant loan, the coordinating committee requested an advisory opinion from the Labor Department in 1980. In 1981, the Department responded by reaffirming that a fiduciary may consider such factors as portfolio diversification, liquidity needs, the projected rate of return relative to the plan's funding objectives, the opportunity for gain and risk of loss associated with the particular investment, the amount of a particular mortgage loan, and the demand for similar loans at various rates, among other factors.

Further, the Department agreed with the NCCMP that a below market mortgage loan might be proper, but that the appropriate rate would depend upon the facts and circumstances of each particular case. Accordingly, a plan fiduciary could consider a wide range of factors relating to the plan—the borrower and the general market conditions.

The Department also said that the concept of prevailing rate of interest was not a single number and did not have to be established according to a single standard.

Interest rates, the Department said, are often determined by considerations such as the term of the loan, security, borrower's equity and discounts, prepayment provisions or knowledge of the borrower's employment background. And the mix of these and other considerations might well allow a low rate to be made available to a plan participant.

Although it did not go as far as we wanted, we considered the Labor Department's advisory opinion to be a breakthrough. We had hopes that this would encourage multiemployer plans to jump into the housing market, a market which need then and now a massive infusion of funds. Unfortunately, we are concerned that the Department is not sticking to its words. Certain litigation which has been instituted in the name of the Secretary of Labor has left the coordinating committee and many of its affiliates with the clear impression that the Department continues to hold the view that investments must adhere to restrictive policies, and that creative mortgage financing must, therefore, be excluded.

Mr. Chairman, I could go on at some length about my views with respect to what are proper investment policies in terms of the prudence and exclusive benefit requirements of ERISA. Furthermore, fiduciaries of collectively bargained plans may have to consider more than percentage return when analyzing an investment. A particular investment such as in a home mortgage, may help to provide additional jobs for participants, and, therefore, additional contributions to the plan. And contributions to the plan pay off past liabilities as well as provide funding for newly accrued benefits. So, too, an investment may help keep the industry that supports the plan healthy. And if the industry is healthy, participants may have additional opportunities to build up service credits for vesting in benefit accrual purposes.

All of these factors have a direct economic impact on the plans and their participants and beneficiaries. Not necessarily in ways that can be quantified and measured in the same terms as a specific interest rate, but in some ways just as important to the plan.

Indeed, Mr. Chairman, it may be that a trustee of a collectively bargained plan breaches his or her fiduciary duty if the factors I have just described are ignored. Perhaps those are the questions that we cannot answer at this hearing. But we can answer the question whether pension plans should be permitted, indeed enthusiastically encouraged, to invest their assets in residential home mortgages.

I do not have to recite to you the grim statistics about the conditions of today's housing industry. In March of 1982, the adjusted annual rate of housing starts dropped 28 percent below the level of the previous year. Unemployment in construction in March of 1982 reached 928,000 people compared to 759,000 last year. And the construction unemployment rate in April of 1982 was 19.4 percent as opposed to 14.7 percent a year earlier.

Mr. Chairman, I might point out that that doesn't tell the story. There are many places in this country where unemployment in construction exceeds 50 and 60 percent.

The industry continues to be in a deep depression. And there simply isn't an availability of loanable funds from traditional sources, and at marketable rates to pull us out of this vortex. I know that the President's Commission on Housing has made a variety of recommendations to make housing more affordable and available. Just last week the House passed a $1 billion mortgage subsidy bill as the first stage in a $5 billion program. Similar legislation has been approved by the Senate Appropriations Committee. It may well be that we are going to have to spend or loan our tax dollars to revive the housing industry. But let us not forget that there is a multibillion-dollar resource available to help with mortgage financing, a resource which is part of the private sector and which can be authorized and appropriated right now. We will need the Government's cooperation to make pension plan mortgage investment programs work. But if the Labor Department can, as it has, bend over backwards to make the restrictive ERISA rules work for plan investment and venture capital projects, it has the ability and the obligation to accomplish similar feats for the housing needs of the American people.

There are those who believe that it may take legislation to free up the plan investments in mortgage loans. And perhaps it will come to that. However, I think that we should try to make ERISA work as its authors intended, both to protect workers' pensions while at the same time to make the best possible use of the vast amount of assets available for sound investments.

And I hope that these hearings will stimulate an even more flexible regulatory approach by the Department of Labor.

Thank you very much.

Senator CHAFEE. Well, thank you, Mr. Georgine.
[The prepared statement follows:]

National Coordinating Committee for Multiemployer Plans

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Statement of Mr. Robert A. Georgine, Chairman,
National Coordinating Committee for Multiemployer Plans
Before the Subcommittee on Savings, Pensions and
Investment Policy of the U.S. Senate Committee on Finance

Mr. Chairman and Members of the Subcommittee:

As Chairman of the National Coordinating Committeee for Multiemployer Plans, I would like to applaud your initiative in conducting these hearings on the investment of pension funds in the home mortgage market. I deeply appreciate the opportunity to present testimony on this important subject.

Let me first describe the Coordinating Committee itself.

The National Coordinating Committee for Multiemployer Plans is a non-profit corporation which was organized to represent the interests of the more than eight million workers who participate in collectively-bargained multiple employer plans. Our affiliates include more than 140 pension, health, and welfare funds, local Taft-Hartley trusts, and related international unions. Together our affiliates represent the great majority of participants in multiemployer plans.

These plans provide benefits for workers in such industries as the retail and service trades, the needle trades, the maritime trades, and the building and construction trades.

Because of frequent job changes in the industries in which these plans exist, a multiemployer plan -- that is, a plan which provides an employee with credit for service with one or more employers -- is often the sole means of assuring that these workers receive a pension.

Mr. Chairman, the overriding responsibility of multiemployer plans is to assure that they are administered and maintained in the sole interest of their participants and beneficiaries. Under the law this is a concept which has many meanings. But when all is said and done it means that those workers who have agreed to defer a part of their current income today will have some modicum of economic security when they retire. Workers have the right to expect to collect the pensions which they have bargained for and which they have earned.

This is a responsibility which we take seriously. And it is for that reason that the Coordinating Committee has consistently and vigorously supported the investment of pension funds in residential home mortgatges.

Pension plan trustees must take a variety of factors into account in administering a plan. To be sure they must meet the minimum vesting, eligibility, benefit accrual, and reporting requirements of the law. And they must see to it that required contributions are paid and that the plan is adequately funded. The enactment of ERISA represented a giant step forward in establishing these most basic of national labor standards.

But, it is shortsighted to assume that those standards have any real meaning unless the financial assets of pension plans produce a reasonable investment return which will assure the payment of promised benefits and unless the base of fund contributions -- the very source of a plan's assets -- remains stable and growing.

The use of pension assets to help finance residential home mortgages is an example of the kind of investment opportunity which serves both of these critical plan objectives. In addition it is the type of investment which will help stimulate our national economy and provide a chance for individuals and families to participate in the American dream of owning their own home.

I must say Mr. Chairman that I am sometimes surprised to find that there are those who consider pension investment in home mortgages to be a brand new idea. As a matter of fact both private and public pension funds have been making their assets available for mortgages for years. Indeed, when I first started out in Chicago, our pension funds were already making mortgage investments.

On a larger and more formal basis, as early as 1959, the Hawaii Employees Retirement System initiated a program providing mortgage loans for its participants at 1 to 2-1/2 percent below so-called prevailing rates. To date, that program constitutes $400 million of the plan's $1.45 billion in investments and there has not been a foreclosure on a single mortgage. Today, state retirement systems in North Carolina, Massachusetts, Texas, Connecticut, Michigan, New York and New Hampshire have instituted mortgage loan programs for their participants and other residents of their states. Further, California, Ohio and Minneapolis-St. Paul are also in the process of establishing mortgage loan investment programs financed in whole or in part by their state or local employee pension plans.

Private pension plans have also been at the cutting edge of home mortgage financing for a number of years. To date, the AFL-CIO Mortgage Investment Trust-I has completed FHA project loans exceeding $300 million in commitments on 131 projects providing more than 13,000 housing units. In Southern California a consortium of multiemployer plans has already invested a portion of nearly $115 million in residential mortgages. And local pension trusts in Northern California, Milwaukee, Washington State, and South Florida have also instituted home mortgage investment programs.

I venture to say that there would be many more examples of pension fund investment in the home mortgage market if it were not for some of the potential impediments of ERISA's fiduciary responsibility and prohibited transactions provisions. I characterize these as "potential" impediments because of my belief that ERISA can and should be flexible enough to permit this important investment opportunity while at the same time providing adequate protection against possible abuse.

And I am proud to say that the Coordinating Committee has been at the forefront of successfully advocating interpretations of the statute which have begun to break down the barriers to pension plan mortgage investments.

As you know Mr. Chairman, certain specific transactions between a plan and a party in interest are absolutely proscribed by the prohibited transactions provisions of ERISA unless statutorily or administratively exempted. The statutory exemptions provide only limited relief with respect to mortgage loans to participants and beneficiaries and in permitting certain parties in interest to provide loan services to the plan. The most important kinds of relief necessary for successful mortgage investment programs must be obtained through administrative exemptions which are within the discretion of the Department of Labor.

During 1976 the Coordinating Committee requested and was granted a class exemption allowing multiemployer plans to provide construction financing for projects using construction contractors who contributed to such plans. This exemption was applicable to residential and non-residential construction and was an important first step toward the objective of opening the door to mortgage loans.

In ensuing years, various multiemployer plans were able to secure individual exemptions permitting them to finance the purchase of industrial and commercial buildings and single family homes which were constructed by employers contributing to those plans. Unfortunately, these individual exemptions tend to become bogged down in the bureaucratic processes of the Department of Labor. They have taken too long a period to be approved, and thus, with the escalating costs of money, the very projects for which mortgage financing was intended have been put at risk.

In view of the growing number of problems with the individual exemption approach the Coordinating Committee decided that multiemployer plans needed a more certain relief from the prohibited transaction provisions if there was going to be any real opportunity to pursue and increase investments in home mortgages. Thus, in May, 1980, we filed an application for a class exemption for transactions related to long-term residential mortgages that involve collectively bargained plans and certain parties in interest such as mortgage bankers, developers and builders, and individuals who are employees of a contributing employer, service provider or union. The NCCMP was pleased that the Labor Department finally issued this exemption last week. Although it is not responsive to all our concerns, we hope that the final class exemption which will not only help the homebuilding industry but provide job opportunities in the construction and related industries and thereby increase the pool of plan contributions and plan assets. Moreover, it will make this most attractive form of investment opportunity more readily available to our multiemployer plans.

But ERISA's prohibited transaction rules are not the only obstacle to plan investments in the home mortgage market. Under the law, plan trustees are required to act prudently and for the exclusive benefit of the plan's participants and beneficiaries. As a union official, as a former plan trustee, as the Chairman of the NCCMP, and as a responsible citizen I fully support this most basic of fiduciary standards.

In June of 1975 the Labor Department published a regulation governing the concept of "prudence" which made eminent good sense as that term is applied to plan investments under ERISA. That rule effectively states that a plan fiduciary must not rely solely on one factor in considering how to invest plan assets but, rather, must consider the entire portfolio in formulating the plan's investment program. The problem which has developed is that the Labor Department has taken public positions which appear to stray from its prudence rule.

In early 1980, as the debate on so-called social investing swept the country, the former Administrator of the Labor Department's ERISA program began suggesting that "rate of return" must be the paramount if not exclusive concern of trustees and that any trustees who took other factors into account were running serious risks of enforcement action by the Department. Although he acknowledged that under certain circumstances other factors should be considered, the entire thrust of the Labor Department's public statements was to put a chill on mortgage programs which were already underway.

As you recall, Mr. Chairman, interest rates three years ago started reaching levels which made it impossible for most workers to afford a home. In the first place, the cost of money significantly increased the cost of construction. Secondly, the cost of borrowing to the purchaser made it prohibitive if indeed the purchaser could even qualify.

In these circumstances many plans began to consider making mortgages available, especially to their own participants, at rates below the artificially high rates posted by local banks.

Officials of the Labor Department immediately began making public statements casting doubts on the legality of these so-called "below-market" mortgages.

In order to clarify this potential problem and to resolve the question of the interest rate which a plan could charge on participant loans, the Coordinating Committee requested an advisory opinion from the Labor Department in 1980. In January of 1981, the Department responded by reaffirming that a fiduciary may consider such factors as portfolio diversification, liquidity needs, the projected rate of return relative to the plan's funding objectives, the opportunity for gain and risk of loss associated with the particular investment, the amount of a particular mortgage loan, and the demand for similar loans at various rates, among other factors. Further, the Department agreed with the NCCMP that a "below market" mortgage loan might be proper but that

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the appropriate rate would depend upon the facts and circumstances of each particular case. Accordingly, a plan fiduciary could consider a wide range of factors relating to the plan, the borrower, and general market conditions. The Department also said that the concept of "prevailing rate of interest" was not a single number and did not have to be established according to a single standard. Interest rates, the Department said, are often determined by considerations such as the term of the loan, security, borrower's equity, discounts, prepayment provisions, or knowledge of the borrowers employment background, and the mix of these and other considerations might well allow a low rate to be made available to a plan participant.

Although it did not go as far as we wanted, we considered the Labor Department's advisory opinion to be a breakthrough. We had hopes that this would encourage multiemployer plans to jump into the housing market -- a market which needed then and now a massive infusion of funds. Unfortunately, we are concerned that the Department is not sticking to its word. Certain litigation which has been instituted in the name of the Secretary of Labor has left the NCCMP and many of its affiliates with the clear impression that the Department continues to hold the view that investments must adhere to restrictive policies and that creative mortgage financing must therefore be excluded.

Mr. Chairman, I could go on at some length about my views with respect to what are proper investment policies in terms of the prudence and exclusive benefit requirements of ERISA. I strongly believe that too many plans have been following the traditional approaches to investment and the evidence is unmistakeable that those policies have yielded miserable returns.

Furthermore, fiduciaries of collectively-bargained plans may have to consider more than percentage return when analyzing an investment.

A particular investment -- such as in a home mortgage -- may help to provide additional jobs for participants and, therefore, additional contributions to the plan. And, contributions to the plan pay off past liabilities as well as provide funding for newly accrued benefits.

So, too, an investment may help keep the industry that supports the plan healthy. And if the industry is healthy participants may have additional opportunities to build up service credits for vesting and benefit accrual purposes.

All of these factors have a direct economic impact on plans and their participants and beneficiaries -- not necessarily in ways that can be quantified and measured in the same terms as a specific interest rate, but in some ways just as important to the plan.

Indeed, Mr. Chairman, it may be that a trustee of a collectively-bargained plan breaches his or her fiduciary duty if the factors I have just described are ignored!

Perhaps those are questions which we cannot answer at this hearing, Mr. Chairman. But we can answer the question whether pension plans should be permitted, indeed enthusiastically encouraged, to invest their assets in residential home mortgages.

I do not have to recite to you the grim statistics about the conditions of today's housing industry: - in March 1982 the adjusted annual rate of housing starts dropped 28 per cent below the level of the previous year. - Unemployment in construction in March 1982 reached 928,000 compared to 759,000 last year and the construction unemployment rate in April, 1982 was 19.4 per cent as opposed to 14.7 per cent a year earlier.

The industry continues to be in a deep depression.

And there simply isn't an availability of loanable funds from traditional sources -- and at marketable rates -- to pull us out of this vortex.

I know that the President's Commission on Housing has made a variety of recommendations to make housing more affordable and available.

Just last week the House passed a $1 billion mortgage subsidy bill as the first stage in a $5 billion program. Similar legislation has been reported out of the Senate Banking Committee and is awaiting floor action.

It may well be that we are going to have to spend or loan our tax dollars to revive the housing industry.

But let us not forget that there is a multi-billion dollar resource available to help with mortgage financing -- a resource which is part of the private sector and which can be authorized and appropriated NOW!

We will need the government's cooperation to make pension plan mortgage investment programs work. But if the Labor Department can -- as it has -- bend over backward to make the restrictive ERISA rules work for plan investment in venture capital projects, it has the ability and the obligation to accomplish similar feats for the housing needs of the American people.

There are those who believe that it may take legislation to free up plan investments in mortgage loans. Perhaps it will come to that. However, I think that we should try to make ERISA work as its authors intended -- both to protect workers' pensions while at the same time to make the best possible use of the vast amount of assets available for sound investments. I hope these hearings will stimulate an even more flexible regulatory approach by the Department of Labor.

Senator CHAFEE. Obviously you are at odds with the administration—Mr. Clayton's statement. What do you think of the proposal that I read in the letter from Mr. Williams, president of the Teamsters, regarding—which is as follows:

Changes in ERISA to allow union pension fund trustees to lend money for home mortgages at below market rates, but above the rates necessary to meet the fund's long-term actuarial projections.

Are you for that?

Mr. GEORGINE. I think it's a good idea. I think it is a very good idea. And it's one that is a long time in coming.

Senator CHAFEE. It seemed to me that in your statement you raised the problems that Mr. Clayton attempted to address. In other words, you said that such investments might provide additional jobs, which would bring more contributors to the fund. And this, of course, is a departure—the fact that you are raising it is that it is contrary to the interpretation of the existing law. And you do agree that the primary objective—never mind the primary—the objective of the fund should be to have it strong and available for the present and future beneficiaries. Is that correct?

Mr. GEORGINE. Absolutely, Mr. Chairman. But we think what we have suggested will make it strong; will make it stronger for that matter. He said it violated commonsense because it would put new people into the plan. I just recited to you unemployment numbers that are staggering. What it would do is put those people that are now in the plan back to work so that they could continue contributing in their behalf, and increase the strength of their pension funds.

Senator CHAFEE. Have you had an opportunity, or Mr. Curran or Mr. Smith, to study new class exemptions which Mr. Clayton and the administration have circulated? And the question is: Would those exemptions help union funds to contribute more to mortgages as you see it?

Mr. GEORGINE. We have studied them. As a matter of fact, that's the one that was 2 years in coming. But we think that it will open the door. We think it is good that it is here. We think it is a little restrictive and that it could be a lot more flexible than it is.

Senator CHAFEE. Basically, as I understand it, it would permit them to go under Ginnie Maes and Fannie Maes. But I am not sure it would permit investment into, say, homes owned by members of the construction trade, for example, solely. Would it?

Mr. GEORGINE. Could I have Mr. Smith answer that? He knows that backward and forward.

Senator CHAFEE. Sure. Go ahead, Mr. Smith.

Mr. SMITH. I believe that it will allow that kind of investment. The reference to the Ginnie Mae and the Fannie Mae is simply a standard that is incorporated into it that individual mortgages which meet the standards set down by Ginnie Mae and Fannie Mae are available for investment.

Senator CHAFEE. But if you came up with some pool of mortgages involving your people, say members of the construction trade, and put it into some kind of a pool, you think that would then qualify as the kind of investment that your fund or other funds could go into?

Mr. SMITH. I think it certainly could under that exemption and the previous exemption which was aimed at pools in particular.

Senator CHAFEE. But then you would have to apply to that the prudence rules to see whether that would rank as attractive an investment as others?

Mr. SMITH. Certainly.

Senator CHAFEE. And you might lose out on that basis.

Mr. SMITH. That's always the possibility. Every investment has to be looked at with an eye toward prudence.

Senator CHAFEE. All right. Assuming that that meets some of your requirements, then what more would you be seeking, Mr. Georgine, in this law? Changes in ERISA?

Mr. GEORGINE. Well, one of the things, of course, would be the opportunity under certain circumstances to make a mortgage loan that was what they call "less than the prevailing rate." There are limitations and restrictions now that make that almost impossible with the Labor Department's attitude. What they have said is their interpretation. Tim, what do you think?

Mr. SMITH. Well, the primary problem is the expressed views of the Department of Labor. They are leading many trustees to believe that they have to charge the same rate as a local bank is quoting even though that is not really the rate that is being charged on loans that are being made. And the public announcements of the Department of Labor have, I think, discouraged a lot of trustees into getting into mortgages because they realize that if they put a program out there that charges the same rate that a bank is quoting, that they won't get any response from that. It will just be a waste of time. So the people are hearing what the Department is saying and they assume that there is no possibility in investing in mortgages without risking the Department of Labor coming in and taking enforcement action.

Mr. GEORGINE. Mr. Chairman, it can be a prudent investment to buy stock at *x* amount of money that loses its value 6 months later and your net return is 4 percent. But they say it can't be a prudent investment to lend money at 12 percent when the savings and loans and banks are lending it at 14 or 16. Yet you are getting 12 percent return on your money. That's where we have the very serious problem. If the return on your investment gives you more than the rest of your portfolio, it is still imprudent. Now that, to me, is a violation of commonsense.

Senator CHAFEE. Mr. Curran, any comments?

Mr. CURRAN. Nothing to add, sir.

Senator CHAFEE. Well, this is a sticky problem. You have been a trustee yourself, Mr. Georgine, so you are familiar with all this. There are more things to look at besides return, as you mentioned. But those other items you look for in addition to return are potential for growth in the investment, for example, if it's an equity, management, security, all those factors figure in besides strictly just a return. But when you are dealing with mortgage versus mortgage, and you have a chance to get 14 percent or get 12 percent, even though the 12 percent might help your members or those who are members of the plan, it seems to me that it presents a challenge to the trustee to go for the 12 percent when he could be getting 14 percent, which obviously produces more for his beneficiaries.

Mr. GEORGINE. But, Mr. Chairman, that's no real figure when they say that the mortgage rate is 15, 16, 17 percent. That's what they are charging for mortgage money if anybody can get it. Nobody can get it because they can't afford to make the payments so they can't qualify for the loan. So that really isn't the mortgage rate. The true mortgage rate is brought down. And mortgage rates go out at 11 and 12 percent. So you can't take a look at what the market is and decide really, in fact, what is the true mortgage rate. What are mortgages really going out at? And I say to you that it is a much lower rate than is published.

Senator CHAFEE. Well, of course, as Mr. Clayton and I discussed, in our meeting with the pension fund managers last week what they found was that investment in mortgages now is just not an area that they found competitive with other long-term obligations. Thus, they didn't feel that's where they wanted to put their money.

Mr. GEORGINE. We don't feel that way.

Senator CHAFEE. Yes.

Mr. GEORGINE. We do feel that there are better investments right now. And our economists will tell you that. And I am sure Henry Schechter will spend a great deal of time on that issue. But the fact of the matter is that there has to be money in the home market. If you are going to revive this economy, you have got to revive the homebuilding industry. And there is money available in pension funds to do just that. And they are good investments. And they will bring a prudent return. And they are safe. And they will do the other things. They will create jobs. And they will strengthen the pension funds. And it just makes good commonsense to make that source of funds available for the homebuilding industry.

Senator CHAFEE. But you yourself recognize that that's not permitted under the current law. Otherwise, you wouldn't be here.

Mr. GEORGINE. That's true. That there are restrictions and prohibitions. There are certain things that we think you can do under current law that the Labor Department won't allow us to do. That's the major problem.

Senator CHAFEE. All right. Fine. Thank you very much, Mr. Georgine, for your testimony. Obviously, that will be helpful to us.

Mr. GEORGINE. Thank you, Senator.

Senator CHAFEE. We appreciate you coming.

Mr. Schechter, we welcome you. There's a vote on now. Why don't you start? And I will have to leave in a few minutes. We will just have a temporary recess while I go over. And, again, if you can summarize your statement, that would be helpful to us. Why don't you proceed, Mr. Schechter?

STATEMENT OF HENRY SCHECHTER, DIRECTOR, OFFICE OF HOUSING AND MONETARY POLICY, AFL-CIO, WASHINGTON, D.C.

Mr. SCHECHTER. Thank you, Mr. Chairman. I appreciate the opportunity to present the views of the AFL-CIO on pension fund investment in mortgages. You have relieved me of making part of my statement by assuring that you are opposed to mandatory requirements for such investment. Of course, there have been proposals of that sort.

I would like to emphasize, though, that the AFL-CIO view is that there is a market range——

Senator CHAFEE. I guess, Mr. Schechter, that we ought to hold right here before you get started. If you would be good enough to remain at ease for a few minutes and I will be right back.

[Whereupon, at 10:42 a.m., the hearing was recessed.]

AFTER RECESS

Senator CHAFEE. All right. Start once again, Mr. Schechter. I apologize. You have been around so you are familiar with the delays. And there is no way in the world I can assure you that that will be the last interruption. Why don't you proceed?

Mr. SCHECHTER. Mr. Chairman, the labor pension funds should not be asked to compensate for the impact of a tight monetary policy, and high interest rates upon the economy by making loans at the expense of workers whose retirement income would be involved. In other words, there is no way of doing that justifiably.

There is, however, a range of mortgage interest rates in the market at any particular time. If there weren't that range, and changes taking place within that range, we would always have one interest rate. It would be very hard to get the market to change.

As Bob Georgine indicated, there are various factors involving the credit risk: different locations of houses, different terms of loans, to value ratio, maturity and so on which would make for a difference, and different credit ratings of the home buyer.

I do believe within that range though, it should also be possible to take account of the benefit which the fund and the participants may reap by having more work as a result of the investment. Mr. Clayton indicated that there would be more liabilities because more work would mean adding people to the plan as beneficiaries. But I think Bob Georgine and I do not have in mind the people who would be added as employees. We have in mind the great numbers of presently unemployed. And when the actuarial funding was designed for any fund, it was for a given number of people working in the trade. In order to be able to meet the payment obligations to them, some of whom will have to be paid very shortly, it is a consideration to have at least reasonably full employment of participants so that the fund can benefit.

I do not believe there should be or could be even much of an impact on home financing as a whole by the pension funds. Even if they grow, let's say, at $25 billion per year, and suppose there were to be a radical departure to invest 10 percent of that in residential mortgages, which would mean $2½ billion a year—but total mortgage investments are $65 to $100 billion a year. Last year, the net residential mortgage investment, according to the Federal Reserve flow of funds figures, was $64 billion. That was a decrease of about $36 billion from 1981 because, primarily, of high interest rates, and the inability to place investment funds in mortgages at the high interest rates that the market was demanding.

Now because of that, for example, the savings and loans decreased their net mortgage lending from $26 billion to $13 billion.

The commercial banks remained about equal, although the year before they had come down from $21 billion in 1979 to $13 billion.

What I am getting at is that if the pension funds, by themselves, were to attempt to bring down the mortgage interest rates greatly, they could not do that. To the extent that they made a very significant impact or began to, funds from other sources would flow away from mortgages into other investments. So we cannot solve the housing finance problem simply by saying pension fund investments can do it. It is the entire credit structure which has to be taken into account.

Now we, for some time, have been recommending the use of credit controls, such as was done in 1980 when we got the prime rate down from about 20 percent to about 11 percent. The mortgage interest rates came down from about 16 to 12 percent in a few months. Housing starts began to pick up. And the economy revived for a while. Japan has used this technique and they have done very well.

Senator CHAFEE. But that's aside from our general thrust.

Mr. SCHECHTER. But I believe, sir, it is applicable in that we cannot do it simply with the pension funds. You asked in your opening statement: "Can pension funds help revive housing?" Incidentally, the latest figure on the seasonally adjusted annual housing starts rate came out yesterday. It's down to 881,000, below 900,000.

Sure, the pension funds can help to some extent, but the funds will always flow to the highest yield. And the different sorts of packaging of mortgages really don't affect that. It may be more convenient. Now we at the AFL-CIO have a mortgage investment trust. We help, in that, we take funds from pension funds and buy mortgages. That makes it simpler for them to invest funds in mortgages through our trust.

But there isn't enough, really, that the pension funds could do to begin to affect this overall situation. And, therefore, I would appeal to you to give consideration to the overall situation, and something else besides monetary policy as a way to fight inflation; namely, credit controls.

[The prepared statement follows:]

Statement of Henry B. Schechter, Director

Office of Housing and Monetary Policy

American Federation of Labor and

Congress of Industrial Organizations

Before the Savings, Pensions and Investment Policy Subcommittee

of the U. S. Senate Finance Committee

on Private Pension Fund Investment in Residential Mortgages

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May ~~3~~, 1982

I appreciate the opportunity to present before you the views of the AFL-CIO on private pension fund investment in residential mortgages.

The AFL-CIO has an interest in each of the various policy facets involved in private pension fund mortgage investment. It has long recognized the need and acted to encourage greater pension fund investment in residential financing. It has also recognized and supported the need for prudence and fiduciary responsibility to all the present and prospective beneficiaries of labor pension funds.

Those two policy positions are compatible. Labor pension funds should not be asked to compensate for high interest rates resulting from national monetary policy at the expense of workers whose retirement income would be involved. To deal with the national housing and economic problem caused by high interest rates, it would be appropriate to have federal support to reduce mortgage interest costs for housing occupants, as was done in 1975-76.

At the same time, it must be recognized that there is always a limited market range of mortgage interest rates, of one or two percentage points, within which prudent investments can be made. In a pension fund mortgage portfolio, there is need for locational diversity, and risk differences that vary with maturity terms and loan-to-value ratios. There is also need to consider the benefit to the pension funds and their beneficiaries from maintaining employment and pension fund income. Investment policy flexibility toward those ends should be justifiable within the mortgage market range of interest rates under the present law. I will develop these points further in a later section of my statement.

Background

There is undoubtedly a great potential for increased mortgage investment by pension funds. The most recent AFL-CIO estimate of assets of all pension funds, based on Labor Department data, shows total assets for all funds of $834 billion. That breaks down into $234 billion* in public employee funds and $550 billion* in private pension funds.

Most of the public employee funds, with over $200 billion in assets, are state and local government employee retirement funds. They are often managed by career employees under management of trustees who are government officials. They do not come under the Employee Retirement Income Security Act, or ERISA.

Of the $550 billion in private employee pension funds, about $368 billion are under collectively bargained agreements and $182 billion not under collectively bargained agreements. Let me just say about the latter that, as long as they are so completely a management entity, labor has practically no influence over their

*These figures are greater than total financial assets figures from Federal Reserve Board flow-of-funds data, cited later. The differences may be due to ownership of some tangible property and also due to different market values of stocks and bonds at different times when data were compiled.

investment policies; and I don't know whether they have any measureable amount in housing mortgages.

The collectively bargained private pension funds are of two kinds. Of the total $368 billion in assets, there is $221 billion in assets in unilaterally controlled funds, practically all controlled by management, and $147 billion in funds under joint labor-management trustee funds. In the latter, we hope to make most progress in encouraging investments in residential mortgages. We also hope, however, that unions will gain some voice in investment policy of the funds of large corporations that are wholly management controlled, and that we might be able to encourage some residential mortgage investment by them.

As shown in the table appended to this statement, at the end of 1981, according to the Federal Reserve Board flow-of-funds data, private pension funds had $4.6 billion or 1.3 percent of total financial assets invested in mortgages. About $1.7 billion or 0.6 of 1 percent of such assets were invested in home mortgages and an unknown amount of the total mortgages held were on residential rental properties. It might be noted that in the early seventies, while the dollar amounts invested by private pension plans were about the same as in 1981, they at that time represented 4 to 5 percent of total assets. There was a sharp drop in such investments after overbuilding and collapse of rental property building values that culminated in 1974. In the last three years there has been growth in pension fund mortgage investment.

Labor Activities Concerning Investment

A few years ago, pursuant to a convention resolution, the AFL-CIO Executive Council created a Committee on Investment of Union Pension Funds which commissioned a study of the subject. When the study report was presented to the Executive Council in August 1980, the Committee Chairman, John Lyons said:

> "The committee's report found that pension funds are invested in companies which are among the most anti-union, export workers' jobs to low-wage countries, ignore workers' needs for health and safety protection and in other ways hinder rather than help workers in the achievement of their most basic and legitimate objectives.
>
> "This situation must be turned around and that is the purpose of the recommendations of the Executive Council of the AFL-CIO which stem from the report and the work of the Executive Council Committee. The major goals of those recommendations are -- by enhancing union participation in pension fund management -- to use these funds for expanding employment, advancing social purposes such as worker housing, improving the ability of workers through their unions to exercise shareholder rights and withholding pension fund investment from companies hostile to workers' rights."

The AFL-CIO believes that the last point is important. Just as nobody here would want to invest his (or her) money in an enterprise that would refuse to hire him (or her) or fellow members of an organization to which he (or she) belongs, the American labor movement will not allow its retirement funds to be used in support of businesses that operate in a manner flagrantly in violation of the interests and rights of workers.

One of the specific recommendations of the report that was approved by the AFL-CIO Executive Council read in part:

> "Certain industries such as construction, transportation, and maritime have special needs. ... An effective way to meet these capital needs and at the same time provide employment is through pension funds investment."

A second recommendation was:

> "That an effort be made to increase participation by pension funds in the AFL-CIO Mortgage Investment Trust in order to encourage investment in government guaranteed mortgages to increase the supply of housing for workers and/or any other projects of a social welfare nature such as health care facilities, where there is a government guarantee of the investment."

The AFL-CIO has operated a nonprofit Mortgage Investment Trust, or MIT, since 1964. It has provided mostly short-term construction financing loans for FHA-insured multifamily projects. This wholly labor controlled Trust has confined itself primarily to such financing because the participating union funds can have their participation certificates redeemed on 60 days notice, and there was no established long-term investment policy.

The AFL-CIO has recently received approval from the Securities Exchange Commission of an application for a second nonprofit trust to be known as the Pooled Investment Trust, or PIT. It is contemplated that participation in that fund will be with an understanding that funds will be invested in long-term, government-insured and guaranteed real estate mortgages. The trust, thus, will provide a relatively safe diversified investment vehicle to finance needed housing and other construction. Furthermore, in order to encourage participation by joint labor-management funds, and even by management controlled pension funds, the PIT fund will be a joint labor-management fund. Half of the trustees will be from labor, half from management, with a neutral chairman. As soon as a number of qualified management trustees have agreed to serve, a registration statement for the sale of participation certificates to eligible labor organizations will be filed with the Securities Exchange Commission.

Another major labor effort to bring pension fund money into investment in union constructed projects was announced earlier this year by President Georgine of the Building and Construction Trades Department of the AFL-CIO who will talk about it in his testimony this morning.

There is already a good deal of investment in new construction by pension funds of various labor union locals, district councils, and national union funds in different regions of the country. The efforts that I have mentioned earlier will be attempts to facilitate, coordinate, and provide risk-reducing diversification for such investments.

Fiduciary Responsibility and Investment Flexibility

There are legal requirements which must be observed by private employee pension funds under the Employee Retirement Income Security Act (ERISA) administered by the Department of Labor. Not being a legal expert, I will not get into the fine points of a trustee's fiduciary responsibility to act as a prudent man, see that there are no conflicts of interest involved, etc.

There is one issue, related directly to mortgage investment, however, upon which I want to comment. The ERISA law and regulations require generally that the assets of a pension plan be administered solely in the interest of beneficiaries and participants, to provide benefits for them, in a prudent manner. The latter objective involves diversifying investments. Both the requirements for addressing the sole benefit of the beneficiaries and participants and need for prudence and diversification play a role in determining the legality of any particular investment. Differences in site locations, in maturity terms, and in loan-to-value ratios all make for differences in risk and commensurate differences in interest rates. In other words, a diversified portfolio that is required for prudent investment policy can leave a narrow margin of flexibility as to yield, but it would still have to be within a narrow market range in order to preserve fiduciary responsibility from the viewpoint of yield.

In a similar fashion, there may be some calculation involved as to the benefits that would adhere to all the beneficiaries by making loans with interest rates at the lower end of the narrow market range of 1 or 2 percentage points, in order to maintain high employment in a trade and payments into a pension fund. Such limited flexibility of investment policy should be possible within the present legal bounds.

Given the great need for housing, particularly for low- and middle-income housing, and the need to revive a depressed economy, there should be some federal support to help fill the gap between market and affordable interest rates. In the 1975-76 period, below-market interest rate financing under the Brooke-Cranston Act and under the permanent special assistance authority of the Government National Mortgage Association was a significant factor in bringing the home building industry and the economy out of recession.

There are two more philosophic points I wish to make. As of now, it is contemplated that the long-term mortgage financing to be done by the new AFL-CIO Pooled Investment Trust would all be in fixed payment, fixed rate loans. We believe that can best serve workers and other home buyers and make for a more stable economy. The various forms of adjustable interest rate, renewable and balloon payment mortgage are a throw back to the late twenties and financing that helped to bring about the Great Depression. Pension fund investors, knowing their long-term actuarial requirements, know how much can and should be invested for paybacks in specific future years. As far as return on investment is concerned, with a relatively steady stream of investment, over the long-run the fluctuations in market rates are likely to provide an average yield that will be as good as a portfolio of variable rate or equity sharing mortgages. And a probable lower default rate should keep even the minimal losses possible under FHA-mortgage insurance at a lower level. If pension funds are to be encouraged, to invest in mortgages, it is highly desirable that FHA mortgage insurance should remain available.

Finally, there have been proposals floated for legislation to require a certain proportion of pension fund investments to be placed in residential mortgages as a condition of continued tax exemption. Such a statutory requirement would place a constraint upon the pension funds in obtaining the highest market yield for a given degree of risk for their beneficiaries. While we hope to increase pension fund investment in residential mortgages, we object to such mandatory requirements for the retirement funds of labor. Nobody is suggesting similar legislation for mutual life insurance companies, or IRA or KEOGH accounts which also hold large amounts of long-term capital funds. Aside from the inequity involved, it really would have little practical impact on the availability and cost of residential mortgage money. As pension funds flow into home mortgages and reduce mortgage interest rates, other sources of long-term funds will shift more funds away from mortgages into other forms of investment, and may in large part offset the shift of pension funds toward mortgages.

Table I

FINANCIAL ASSETS OF PRIVATE PENSION FUNDS
(in billions of dollars)

Year	Total Financial Assets	Demand Deposits & Currency	Time Deposits	Corporate Equities	Credit Mkt. Instruments	Treasury Issues	Agency Issues	Corporate Bonds	Mortgages	Home Mortgages	Misc. Assets
1967	$ 89.4	$0.9	$0.4	$51.1	$32.8	$2.0	$0.3	$26.4	$4.1	$1.8	$4.2
1968	101.5	1.0	0.6	61.5	33.8	2.4	0.4	27.0	4.1	1.8	4.6
1969	102.4	1.0	0.6	61.4	34.6	2.2	0.6	27.6	4.2	1.8	4.7
1970	110.4	1.1	0.7	67.1	36.6	2.1	0.9	29.4	4.2	1.8	4.9
1971	130.1	1.3	0.3	88.7	35.0	2.1	0.6	28.6	3.7	1.5	4.8
1972	156.1	1.6	0.3	115.2	34.0	3.0	0.7	27.6	2.7	1.1	5.0
1973	134.3	1.4	1.1	90.5	36.3	3.1	1.3	29.5	2.4	0.8	5.1
1974	115.5	1.3	3.7	63.3	41.9	3.0	2.6	34.0	2.4	0.8	5.3
1975	146.8	1.5	2.4	88.6	48.9	7.4	3.3	35.8	2.4	0.7	5.5
1976	171.9	1.6	2.3	109.7	52.5	11.1	3.6	35.5	2.4	0.6	5.7
1977	178.3	1.7	4.8	101.9	64.7	15.9	4.2	42.1	2.5	0.6	5.2
1978	198.3	1.8	10.3	107.9	73.0	17.5	4.7	48.0	2.8	0.9	5.4
1979	222.0	1.9	8.9	123.7	81.8	19.4	5.6	53.7	3.1	1.2	5.8
1980	286.8	1.9	10.3	175.8	92.6	24.1	6.7	58.1	3.7	1.6	6.2
1981	294.8	2.0	13.0	167.1	106.1	32.1	9.3	61.7	3.9	1.7	6.6
					Percent Distribution						
1967	100.0%	1.0%	0.4%	57.2%	36.7%	2.2%	0.3%	29.5%	4.6%	2.0%	4.7%
1968	100.0	0.9	0.6	60.6	33.3	2.4	0.4	26.6	4.0	1.8	4.5
1969	100.0	1.0	0.6	60.0	33.8	2.1	0.6	27.0	4.1	1.8	4.6
1970	100.0	1.0	0.6	60.7	33.2	1.9	0.8	26.6	3.8	1.6	4.4
1971	100.0	1.0	0.2	68.2	26.9	1.6	0.5	22.0	2.8	1.1	3.7
1972	100.0	1.0	0.2	73.8	22.8	1.9	0.4	17.6	1.7	0.7	3.2
1973	100.0	1.0	0.8	67.4	27.0	2.3	1.0	22.0	1.8	0.6	3.8
1974	100.0	1.1	3.2	54.8	36.3	2.6	2.2	29.4	2.1	0.7	4.5
1975	100.0	1.0	1.6	60.3	33.3	5.0	2.2	24.4	1.6	0.5	3.7
1976	100.0	0.9	1.3	63.8	30.6	6.3	2.1	20.7	1.4	0.3	3.2
1977	100.0	0.9	2.6	57.1	36.3	8.9	2.3	23.6	1.4	0.3	2.9
1978	100.0	0.9	5.2	54.4	36.8	8.8	2.4	24.2	1.4	0.5	2.7
1979	100.0	0.9	4.0	55.6	36.8	8.7	2.5	24.1	1.4	0.5	2.6
1980	100.0	0.7	3.6	61.3	32.3	8.4	2.3	20.3	1.3	0.6	2.2
1981	100.0	0.7	4.4	56.7	36.0	10.6	3.2	20.9	1.3	0.6	2.2

SOURCE: Flow of Funds, 1969-1979, p. 12, 19.

NOTE: Details may not add to totals due to rounding.

Senator CHAFEE. Well, what specifically? I got that last point you were making. But what specifically would you have us do in connection with ERISA?

Mr. SCHECHTER. I think the Labor Department should specifically recognize that there is a range of mortgage interest rates on the market at all times.

Senator CHAFEE. That was the point Bob was making, Mr. Georgine was making. That the difference between 14 and 12 or whatever it is.

Mr. SCHECHTER. Well, I am not using the same figures. But about a 2-point range. That should be recognized. And, furthermore, from the point of view of a prudent trustee, he should recognize that if investments are made toward the bottom of that market range, taking into account the fact that it may help in reemploying some of the unemployed proposed beneficiaries, and assure that their benefits will be there, I think that should be recognized.

Senator CHAFEE. Do you find currently—perhaps you haven't had a chance to analyze this—that union funds make more real estate investments—union pension funds—than nonunion pension funds?

Mr. SCHECHTER. There are not figures of that sort to the best of my knowledge.

Senator CHAFEE. I notice in your written testimony you suggest that the nonunion ones—you say, "I don't know whether they have any measureable amount in housing."

Mr. SCHECHTER. Yes; the reason I say that is the amount is relatively small anyway.

Senator CHAFEE. Yes.

Mr. SCHECHTER. And I know that there are union funds going into mortgages. In fact, there was a listing in the Investment Journal recently of the 10 largest pension funds with different sorts of assets. And among those 10, there were 3 listed there—2 very large union funds—with very large amounts in mortgages.

Senator CHAFEE. Does there exist a system now whereby union members have their mortgages pooled in some manner or does each member just go to his local bank or S. & L.?

Mr. SCHECHTER. I think they go to the traditional lenders. Sure, a lot of the mortgage investment is not done by a pension fund making the loan to the borrower. They are not equipped to do that.

Senator CHAFEE. No.

Mr. SCHECHTER. They work through, perhaps, mortgage bankers or somebody else.

Senator CHAFEE. Right.

All right. Thank you very much, Mr. Schechter. We appreciate your testimony. And we are delighted that you came today.

Now we have a panel of Mr. Carl, Mr. Carlson, Mr. Pryde, and Mr. Johnson, all representing the realtors or homebuilders and the President's Commission. And, Mr. Carl, you will be presenting the recommendations of the President's Commission on Housing of which you were a member, so why don't you proceed.

Now, gentlemen, we do have time constraints, and we are running a little behind because of these votes. I would like to complete this by noon if we can. Why don't each of you take about 3 or 4 minutes apiece? And if there is more time, we will provide it.

STATEMENT OF BERNARD J. CARL, WILLIAMS & CONNOLLY, WASHINGTON, D.C., ON BEHALF OF THE PRESIDENT'S COMMISSION ON HOUSING

Mr. CARL. Thank you, Mr. Chairman.

The President's Commission on Housing was created in June 1981, and issued its final report on April 30, 1982. It is a 700-page report that is a very comprehensive look at the future of housing and housing finance in this country. It focused heavily on the question of mortgage credit, understanding that the lifeblood of the housing industry is the availability of credit for mortgages. It focused heavily, as well, on pension funds as significant potential future sources of mortgage credit.

It may be useful to put that focus in perspective. The mortgage finance system is a system in transition. It has historically depended heavily on the thrift institutions.

Senator CHAFEE. Mr. Carl, when did you complete the report?

Mr. CARL. April 30 of this year. And it was provided to the President on April 30.

Senator CHAFEE. So we are just 20 days thereafter?

Mr. CARL. Yes, Mr. Chairman.

Senator CHAFEE. Thank you.

Mr. CARL. Historically, we have depended on the thrift institutions which are specialized institutions for individual savings. The role of the thrift institution is changing. Its role has been partially supplanted by contract saving plans, such as the pension funds. It has also found competition for savers' funds from other investment vehicles such as mutual funds. In addition, volatile rates have impacted on the ability of thrift institutions to finance long term mortgages in their portfolios on the basis of short term deposits. The nature of this transition process is evidenced by the fact that thrifts, which historically have provided more than half of all mortgage credit, provided less than 8 percent of net new mortgage originations in the second half of 1982.

That evidence suggested to us that, in order to have a viable housing industry in the future, the housing industry must look to new sources of mortgage credit, and to broader access to the capital markets, including the pension funds. We looked particularly to the pension funds because of their historic similarity to the thrifts as a place for long-term savings, because of the long term nature of their obligations, which unusually fit the need for mortgage credit, which involves long-term instruments. When we looked at pension funds, we discovered that about 2 percent of public pension fund assets are invested in mortgages. This suggested to us that there is substantial potential for expansion of the investment of pension funds in mortgage credit.

We then went on to discuss with pension fund managers and others what are the deterrents to pension funds investing in housing. And one of the major deterrents we found was the ERISA statute. Both the prohibited transactions rules of ERISA and the plan asset definition constituted such impediments.

On October 31 the Commission, in an early interim report, recommended certain class exemptions from the prohibited transaction rule. The President announced on December 3 of last year the first set of such exemptions. The Commission continued to work with the Department of Labor. And the Department of Labor, I must say, was very responsive to our requests. On Thursday, the Department of Labor issued two new exemptions and a new plan asset regulation which are based largely on our suggestions. We think these are important steps in the direction of increasing mortgage investments by pension funds. But they have problems. The exemptions omit any reference to multifamily housing, which is obviously an important part of the housing system. Also, the reliance on mortgages that are eligible for purchase by Fannie Mae and Freddy Mac effectively limit the principal amount of a mortgage eligible for purchase by a pension fund to those eligible by statute for purchase by those two institutions.

Perhaps the most difficult problem posed by the newly announced Labor Department regulations is the plan asset exemption which applies only to federally related securities—those guaranteed by Ginnie Mae, Fannie Mae, or Freddy Mac. It excludes all conventional mortgage backed securities. The result is potentially to stifle an important new industry, an important new vehicle for reaching the capital markets.

Also, the result may be inadvertently to increase the Federal credit budget by funneling more and more mortgage activity through federally related intermediaries.

We believe it is important, if pension funds are to have significant investments in housing, to increase the viability of conventional mortgage backed securities markets. In that regard, the Commission has proposed a whole series of statutory changes, including some tax law changes within the province of this committee, to make conventional mortgage backed securities more viable. And we believe these are important recommendations to increase the investment of pension funds in mortgages.

Finally, we have looked at the question of tax subsidies to housing. We noted that there are a number of tax subsidies, such as the bad debt reserve for savings and loans and the exemption from taxation of mortgage revenue bonds—all of which do nothing to increase the investment of pension funds in housing. What we proposed instead, but only as a long-range objective, is that Congress give consideration to a tax credit for investment in mortgages, structured in a way that also provides an incentive to important tax-exempt sources of funds, such as pension funds.

We hope that the Congress will consider our recommendations as mechanisms to increase the availability of funds for housing, not only from pension funds, but from other major participants in the capital markets.

Thank you.

Senator CHAFEE. Mr. Carl, I didn't understand the last suggestion. Pension funds being tax-exempt would have some tax benefits available for these tax-exempt funds. How would that work?

Mr. CARL. Mr. Chairman, there are already tax subsidies to housing, such as the bad debt exclusion applicable to savings and loans. To some extent, those may push down the yield on mortgages and make it ultimately, when rates go down, less attractive for pension funds to invest. What we have suggested is something based on the study on financial institution reform done in 1975—a tax credit applicable to the interest generated by investments in mortgages. This would be a uniform tax credit available to all individuals or institutions who held mortgage investments in their portfolios. For example, if you generated income from a mortgage in a given year, you would receive a tax credit equal to a certain percentage of that sum. That credit could be made available to pension funds in one of two ways. It could either be a refundable tax credit, or it could be structured so that the tax credit, as in a leasing transaction, would be available to the originator of the mortgage or to the holder of the security based on the mortgage. And, if it were retained by the orginator, he could, therefore, provide the mortgage to the pension fund at a lower price and a higher yield. In that way, you could have a tax mechanism that applied equally to all investors in this particular investment medium.

Senator CHAFEE. Why don't you, if you would, Mr. Carl, submit for the record the recommendations of the Commission dealing with pension fund investments? Would you do that?

Mr. CARL. Yes, Mr. Chairman, I will do so.

Senator CHAFEE. Fine. Thank you.

STATEMENT OF DR. JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, D.C.

Senator CHAFEE. All right. Mr. Carlson.

Mr. CARLSON. I am pleased to appear on behalf of the National Association of Realtors. We feel that it is very appropriate for this Subcommittee on Savings, Pensions, and Investment Policy to provide oversight of ERISA.

We support the President's Housing Commission's recommendations as described except we would not eliminate the bad debt reserves, thereby causing taxes to increase on thrifts. But we would support what has just been described to you—an investment tax credit for those who would hold mortgage investments.

We do think the steps taken by the administration to remove barriers—not to mandate investment in residential mortgages, but merely to remove barriers—is a wise step to take. Expanding the class exemption under the prohibited transactions to new and existing residential mortgages is a wise step. However, we do believe it is arbitrary to have the eligibility determined by the eligibility for mortgages purchased by Fannie Mae and Freddy Mac. Soundness should be identified. That's wise, but not necessarily the appropriate channel that it should go through.

For example, if you use the eligibility rules for Fannie Mae right now as limiting, there are many parts of California—there might even be parts of Rhode Island and many other large cities, and certainly the District of Columbia area that could not have some of this mortgage to qualify because of the $107,000 limit that now is imposed upon Fannie Mae.

Second, it is not wise because of competitive considerations—allowing the eligibility of those institutions, which are a few, to somehow dictate the marketplace for all investment on the pension side.

Second, we support the expanded acceptability plan assets on the mortgage backed securities. However, we agree with the Housing Commission that we are concerned with the fact that these only go through those that are guaranteed by Fannie Mae and Freddy Mac. It should be broadened. There are many other ways to share the risks other than through those instrumentalities. And we should look into it. Also, again, we do not want to cause some lack of competition by building up the competitive edge that these institutions would have.

We do agree with the Labor Department's improvement on the mortgage pool investment, clarifying self-dealing. And also allowing first and second mortgages.

We are supportive of the steps that have been taken. However, we see these additional ones that I have just described that could further strengthen the ability for residential mortgages to be purchased by pension funds as good investments; not mandated to be purchased by pension funds.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you, Doctor. We appreciate that.

[The prepared statement follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
MORTGAGE INVESTMENT BY PENSION FUNDS
to the
SENATE FINANCE SUBCOMMITTEE ON SAVINGS,
PENSIONS AND INVESTMENT POLICY
by
DR. JACK CARLSON
MAY 19, 1982

I am Jack Carlson, Executive Vice President of the NATIONAL ASSOCIATION OF REALTORS®.

On behalf of the 640,000 members of the National Association, we greatly appreciate the opportunity to present our views on the desirability of mortgage investments by pension funds.

The National Association strongly supports efforts to increase pension fund investments in mortgages. Such activity would benefit both housing and the pension funds making such investments. Housing would benefit because traditional mortgage lenders are withdrawing from the mortgage investment scene. Pension funds would benefit because the historical return on investment in housing has been far greater than the return on investment experienced by the average pension fund.

We have strongly encouraged the Administration to take regulatory actions to ease ERISA restrictions on housing-related investments by pension funds. We view the regulations published last week by the Department of Labor as a constructive step and a clear signal from the Administration. However, much remains to be done, including the following:

- A major marketing effort must commence with the private sector and government entities working to encourage greater pension fund investment in housing.

- Pension funds must be educated about the potential benefits of housing investment including the role of mortgage-backed securities.
- ERISA should work to fine-tune and expand its regulations so that the ingenuity and energy of the marketplace can be most effectively utilized.
- Legislative actions should be taken to ensure that mortgage-backed securities can compete with other forms of capital.

Because of the current housing capital crisis we encourage Congress to do all it can to eliminate the real or perceived restrictions on mortgage investments caused by the Employee Retirement Income Security Act of 1974 (ERISA).

We have seen the traditional source of funds for housing, deposits in the nation's thrift institutions, dwindle to the point that they no longer can adequately function. The outflow of money from the thrifts has been harmful to those American families seeking to purchase a home, and the Congress and the housing industry must explore all possible alternative sources of funding for housing.

Pension funds have equity to invest, they have specific income needs, and they can invest in the longer-term, so they present an ideal source for housing credit, but regulatory, statutory, and marketplace impediments must be removed. At the end of 1981, private pension plans held assets over $500 billion, with minimal investment in housing. The Congress must work to see that this major opportunity to assist housing is not missed.

We view the mortgage-backed security or pass-through security as the primary conduit for pension dollars into individual mortgages which are combined into large mortgage pools. Mortgage-backed securities provide their holders a right to the income streams generated by individual mortgages. As we all know, mortgages are now competitive with other forms of capital and these income flows will be attractive to pension funds. Since fiduciary managers already invest in a variety of securities, the pass-through's present a relatively familiar business option. These securities enable an entity with little or no mortgage lending experience to make well-informed and profitable decisions with respect to the purchase of mortgage-backed securities. Pass-through's can provide increased balance and higher yield to a pension fund portfolio.

When ERISA was enacted there was a conscious effort to assure the integrity of pension funds and to ensure that retirement funds were not misused or imperiled. ERISA therefore requires, and properly so, that pension fund managers make only prudent investments and prohibits self-dealing by such managers. Unfortunately, there is now a perception that investments in anything other than stocks or bonds is not prudent. This perception has resulted in large part due to overly restrictive ERISA regulations which have taken inordinately long to revise. We would submit that housing investments will be good investments for pension funds, and we applaud this subcommittee's concern to see that the relationship between pension funds and housing is strengthened.

Last week, the Department of Labor announced its long-awaited ERISA housing regulations, and our initial review of them indicates that progress has been made on the regulatory front. The regulations indicate that the Department of Labor clearly approves of various forms of housing related investments by pension funds. Specifically:

- The regulations broaden the December 1982 proposed Class Exemption regulation to expand the class exemption to allow pension fund dealing in mortgages on new <u>and</u> existing homes. We are pleased that the final regulation includes our recommendation that existing housing be included in this class exemption.

- The regulations also authorize pension funds, under the definition of plan assets, to invest in the mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (FHLMC). We believe that mortgage-backed securities hold the greatest promise for providing housing capital in the future.

The NATIONAL ASSOCIATION OF REALTORS® feels that these regulations will play an important part in the task of attracting private pension plan investment to provide needed capital for homeownership. The needs and problems of pension fund managers must be met to facilitate housing investment on the part of pension funds. Since the funds are closely regulated, and correctly so, by the Department of Labor, these regulations send a clear positive signal to the pension funds. Having said that, I would like to express some other observations on these regulations.

• The plan asset regulation is perhaps limited in that mortgage-backed securities are restricted to those guaranteed by the FHLMC and FNMA. We believe that the regulations should allow more players in the marketplace to participate in the marketing of mortgage-backed certificates to pension funds. These regulations should be flexible, but should assure the soundness of the investment. Surely this can be done other than by the guarantee of quasi-governmental agencies. The spectrum of the investment needs of pension funds would be better served by many participants than by few.

The marketplace already has developed means to share risk and the ERISA should permit the expertise of the marketplace to be harnessed. By restricting mortgage-backed securities to those of GNMA, FNMA, and FHLMC, these government agencies are in a position to dominate the market. This could also serve to limit the housing investment options of pension funds.

• The class exemption, while it includes existing mortgages, an improvement over the initially proposed regulations, limits these mortgages to those eligible for purchase by FNMA and FHLMC. It should be remembered that these agencies serve a public as well as a private purpose and therefore they are restricted from participating in the marketing of more expensive housing. One must question if this regulation should also limit pension fund participation on the side of more expensive homes.

It must be remembered that the primary reason, as far as ERISA is concerned, that pension funds should invest in housing is that it is a good investment. While the security of pension funds is of paramount importance, the secondary social benefits are significant. Therefore, pension funds should have the widest possible choices of investment, and this includes the making of mortgages above the statutory limits of FNMA and FHLMC.

While we are generally pleased with the new ERISA regulations, we hope that future regulatory actions will not take inordinately long periods of time. We recognize the need for care in expanding investment options for pension funds, but we would remind the Committee that unnecessary delays help no one.

The ERISA regulations are only a part of the work that the federal government and the private sector must do to stimulate pension fund investment in housing. We have not only supported the efforts of HUD, the Mortgage Bankers Association, and the National Association of Home Builders to "sell" pension fund managers on housing, we have also conducted training sessions for our members to work with pension funds so that REALTORS® will be active partners in the housing-pension fund relationship or pass-through security.

As I mentioned earlier, we view mortgage-backed securities as the primary means of tapping pension funds, and other large institutional investors. This Subcommittee should be aware that these securities cannot compete equitably with corporate debt obligations and I would urge that the Subcommittee explore the recommendations of the President's Commission on Housing in this matter.

In closing, I would like to express the Association's thanks for this hearing, as it is an indication of Congressional support and a commitment to pension fund investment in housing. The NATIONAL ASSOCIATION OF REALTORS® stands ready to assist in any way possible in this effort.

We believe that pension funds should have every opportunity to invest in housing. Given the chance, we believe that the funds will indeed choose from the various forms of housing investment that will be available to them.

STATEMENT OF HARRY PRYDE, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Senator CHAFEE. Mr. Pryde.

Mr. PRYDE. Thank you, Mr. Chairman. I am first vice president of the National Association of Home Builders, and a builder-developer from Seattle. I am accompanied by Stuart Lewis, our counsel.

I will try to briefly summarize. But I would like to emphasize that housing starts did drop 6 percent last month and also in March.

We have basically two problems. First is that the exemption still treats mortgage investments as an inferior type of investment. As our prepared statement demonstrates, mortgages have historically proven to be a superior form of investment. Notwithstanding their economic superiority, however, the final exemption places numerous burdens on a plan that wishes to invest in residential mortgages.

For example, the type of mortgage loans that a plan may acquire are limited to recognized mortgage loans as defined in the exemptions. These recognized mortgage loans are essentially mortgages that qualify only under Fannie Mae, Ginnie Mae, and Freddy Mac. Limiting the type of mortgage investments in this fashion is equivalent to prohibiting trustees from buying corporate bonds that do not have triple A ratings. Further, and perhaps most important, the trustees of the plan cannot, by themselves, make the decision to invest in residential mortgages. It must delegate the decision to a qualified real estate manager. Retaining the services of a qualifed real estate manager would involve added expense and complications for the plan. And, moreover, the Labor Department's concerns over the appropriateness of the investment should have been adequately solved by requiring satisfaction of either of these conditions. Requiring both to be satisfied is administrative overkill.

Our second major problem that is unsolved by the exemption concerns the rate of return that must be obtained on any mortgage loan acquired by a plan. While the exemption does not address this issue, the Labor Department has made it clear that their interpretation of ERISA's prudent man rule requires the plan must obtain the highest rate of return available on mortgage loans if it wishes to make these types of investments.

We do not disagree that the plan trustees have a duty to invest plan assets in a manner that is in the best interest of plan participants and beneficiaries. We submit, however, that strict dogmatic adherence to the principle that the rate of return must be the highest possible is not necessarily in the best interest of plan participants and beneficiaries. And may be a substantial detriment in many cases.

Plan trustees should have the clear authority to consider all relevant economic factors in investing the plan's assets. The straightjacket of having to obtain the highest possible rate of return on a mortgage asset rather than obtaining a reasonable or prudent return, in light of all economic circumstances, can be a substantial detriment to the participants and beneficiaries. The reduction in the rate of earnings may have a beneficial effect in securing jobs in pension factors that should be relevant to the trustees' investment decision.

Given these problems, there is a clear, immediate and urgent need for Congress to enact legislation that will remove the second class investment status that has been assigned to mortgages. The mortgages that plan trustees acquire should not be circumscribed to a particular class of mortgages. But, rather, the trustees should be free to acquire any mortgages that they feel are financially sound. If trustees feel that mortgages other than those outlined in the exemptions are suitable investments, just as if the trustees wish to acquire stock or other blue chip securities, the trustees should be free to do so in their best judgment. Further, under ERISA the trustees are given the responsibility and authority to direct and control the investment of plan assets. The trustees should also have this responsibility for mortgage investments thereby, avoiding the expense and burden of having to retain an outside specialist to make one class of plan investments.

NAHB requests that this subcommittee immediately take action to develop legislation that will accomplish this goal. NAHB is ready, willing and able to provide any necessary assistance in the development of appropriate legislation.

Thank you, Mr. Chairman, for your consideration.

Senator CHAFEE. Thank you, Mr. Pryde.

[The prepared statement follows:]

Statement
on Behalf of the National Association
of Home Builders of the United States

Before the Subcommittee on
Savings, Pensions and Investment Policy
of the U.S. Senate Committee on Finance

May 19, 1982

My name is Harry Pryde. I am First Vice President of the National Association of Home Builders. I am accompanied by Robert Bannister, Senior Staff Vice President for Governmental Affairs and Stuart Lewis, our counsel, who is a partner in the firm of Silverstein and Mullens. We are pleased to be here to testify on investments in residential mortgages by pension and other retirement plans.

The National Association of Homebuilders, with its affiliated state and local organizations, has a membership of approximately 115,000 homebuilders and individuals working in related fields. We are the largest organization representing homebuilders in the United States. Our members are annually responsible for the construction of approximately 67 percent of all new homes.

I. The Problem

The housing industry today is in a severe depression due largely to the high rates of mortgage interest and the shortage of residential mortgage money. The shortage of mortgage investment capital at reasonable rates results in significant part from the disintermediation suffered by the thrift institutions because of bond, money market fund and certificate of deposit yields. Thrift institutions have been the principal supporters of the residential mortgage market for over forty years. Today's interest rates have priced many middle-income families and first-time buyers out of the housing market causing the housing industry to suffer its worst economic downturn in 40 years.

New housing production for 1981 was the lowest since 1946 -- only 1.1 million units were produced. New home sales in 1981 were the lowest ever recorded. The existing home market has been similarly affected with a monthly sale rate that has declined from about 4 million single family homes in 1978 to below two million at the present time.

The failure rate among construction firms was up more than 50 percent. The unemployment rate in the construction industry is now 19.4 percent. This is more than twice the national average. At the beginning of this year, the number of unemployed construction workers rose to well over one million persons.

NAHB estimates that the downturn has cost the American economy more than 3 million man-years of employment, $53 billion in wages and $23.7 billion in total tax revenues, a combined impact of $240 billion.

If these statistics are not sufficient to make the actual devastation to our industry clear, the results of a recent survey of NAHB's membership is a poignant revelation of the extent of the hardship. Of those polled, only 25 percent said they were experiencing profits. Twenty five percent said they were breaking even, and 50 percent indicated they were in the red. Of those who were losing money, the average time for which they estimated they could survive was only eight more months.

Of all the housing cycles since the end of World War II, this downturn is the longest and the most difficult that the housing industry has ever experienced. If something is not done immediately to open up new sources of mortgage investment capital and to bring down high interest rates, contractors will go under in droves and the numbers which I have cited today will rise exponentially.

Another facet of this problem involves the current movement to eliminate the distinctions between savings and loan associations and banks. Savings and loans have historically been the single major source of long-term stable mortgage funds. As financial institutions are restructured the availability of thrift institutions as a source of stable, long-term mortgage financing is jeopardized. Historically pension funds have invested less than three percent of their assets in mortgages, including commercial mortgages. In the future, however, pension funds will be the only major stable source of long-term mortgage financing. It is imperative to the housing industry and the American economy that unnecessary legal impediments to mortgage investments by pension funds be removed.

For these reasons, NAHB is grateful for the opportunity to present its views on an issue that may begin to solve these problems by removing artificial barriers created under our pension laws that have substantially inhibited the nation's employee pension funds from investing in home mortgages. We must stress, however, that the severe plight of the housing industry requires immediate, forceful action from Congress. Further, NAHB submits these issues should be resolved before Congress moves any further toward restructuring thrift institutions.

II. <u>Current Law</u>

Sections 404 through 408 of ERISA establish standards which were designed to: (1) encourage safe and sound investments yielding acceptable returns that are in the best interests of the plan participants, and (2) protect pension plan participants from improper dealings by plan fiduciaries and other parties in interest.

The Congressional assumption behind the adoption of these provisions in 1974 was that dealings between pension funds and related parties are inherently subject to abuse. Because it is difficult to police these types of transactions, Congress enacted a general prohibition on all dealings between funds and related parties. Unlike most investment transactions, mortgage transactions usually involve a large number of parties including not only employers and employees but also builders, developers, unions, mortgage bankers and other types of financial institutions. Because of the large number of parties in interest typically involved in mortgage transactions, a mortgage investment is more likely to be classified as a prohibited transaction than other types of investments. Plan trustees are inhibited from engaging in such transactions because there is a significant risk that they might inadvertently engage in a prohibited transaction. Thus, as a practical matter, the ERISA prohibited transaction provisions preclude plan investments in mortgages, even if the transactions are fair and at arm's length.

In recognition that these overly restrictive prohibition provisions preclude transactions that do not involve abuse, Congress established special administrative procedures for obtaining relief from the prohibited transaction restrictions by petitioning the Labor Department. Unfortunately, that administrative exemption procedure has proved largely unworkable in operation. Obtaining a prohibited transaction exemption through the Department is extremely difficult. Exemptions are only obtained after months and sometimes years of delay and often involve expense that is well beyond the means of small plans. Our recent experience in obtaining such an Exemption illustrates this difficulty.

III. Solutions

Presently only two courses of action are available that could provide substantial relief from these problems -- administrative exemption from the Department of Labor or statutory relief from Congress. The Department of Labor has very recently granted our requested Exemption, but as I will describe in greater detail, the relief is not complete and Congressional action is still urgently required.

A. Prohibited Transaction Exemption

In June of 1980 NAHB and the National Coordinating Committee for Multiemployer Plans

(NCCMP) requested the Department of Labor to issue an administrative exemption that would permit plans to invest in residential mortgages under certain conditions. On December 2, 1981, the Department issued a notice of a proposed class exemption for transactions involving certain residential mortgage financing arrangements (Applications D-1937, D-2004). Unfortunately, this proposed Exemption, in addition to the delay in its issuance, failed to recognize the realities of the mortgage market and was far too restrictive to provide the type of relief required. We testified in detail on these problems last January before the Subcommittee on Labor of the Senate Committee on Labor and Human Resources. Last February, NAHB and others requested the Department to substantially modify this proposed Exemption.

In the last few days the Department of Labor issued Prohibited Transaction Exemption 82-87. This exemption is in response to the original NAHB application filed almost two years earlier. We wish to commend the Department of Labor generally on its responsiveness to the requests of NAHB. The final exemption represents a substantial improvement over the exemption proposed last December. We also particularly wish to commend the Department of Labor for its foresight in changing the basic thrust of the Exemption. As finalized, the Exemption recognizes the flexibility of the mortgage marketplace and attempts to utilize criteria established by agencies whose principal function is to deal with residential mortgages. The Department of Labor in effect delegated the establishment of most of the criteria to organizations such as the Federal National Mortgage Association (FNMA). Since we hope that FNMA and the other government agencies will adapt to changes in the marketplace, amendments to this Exemption may not be necessary to adjust to these economic changes.

While we commend the Department of Labor for having made substantial improvements in the final Exemption, we must point out, however, that the Exemption does not provide all the relief that is necessary. Two main problems still remain after the issuance of the final Exemption. The first is that the Exemption still treats mortgage investments as an inferior type of investment by pension plans. As the accompanying chart demonstrates, mortgages, in fact, have proven to be a superior form of investment, especially for pension plans, than any other common types of investment made by pension plans. Notwithstanding their economic superiority, however, the final Exemption places numerous burdens on a plan that wishes to invest in residential mortgages. For example, the types of mortgage loans that a plan may acquire are limited to "recognized mortgage loans" as defined in the Exemption. These "recognized mortgage loans" are essentially mortgages that qualify under a FNMA, Government National Mortgage Association (GNMA), or Federal Home Loan Mortgage Corporation (FHLMC) program. Limiting the types of mortgage investments in this fashion is the equivalent of prohibiting trustees from buying corporate bonds that do not have an AAA rating. Further, and perhaps most important, the trustees of the plan cannot by themselves make the decision to invest in residential mortgages but must delegate this decision to a "qualified real estate manager". Retaining the services of a qualified real estate manager will necessarily involve added expense and complication for the plan. Moreover, the Labor Department's concerns over the appropriateness of the investment should have been adequately solved by requiring satisfaction of either of these conditions -- requiring both to be satisfied is administrative overkill.

In short, the various conditions imposed in the Exemption have added cost, administrative burdens and layers of complexity that will have the practical effect of making mortgage investments a second class investment when compared to equities, bonds and other forms of investment.

We also wish to note that the Labor Department chose not to extend the Exemption to multifamily housing, even though requested to do so. NAHB now faces the necessity of seeking a separate exemption if it wishes to avoid prohibited transaction problems for pension investments in multifamily housing.

The second major problem that is unsolved by the Exemption concerns the rate of return that must be obtained on any mortgage loan acquired by a plan. While the Exemption does not address this issue, the Labor Department has made it very clear that their interpretation of ERISA's prudent man rule requires that the plan must obtain the highest rate of return available on mortgage loans if it wishes to make that type of investment. The Labor Department has consistently required a "reasonable" rate of return on investments -- a concept to which NAHB does not object. However, as more precisely interpreted by Labor Department officials, we understand the Department's position to be that "reasonable" means the highest available return. We do not disagree that the plan trustees have a duty to invest plan assets in a manner that is in the best interest of plan participants and beneficiaries. We submit, however, that strict dogmatic adherence to the principal that the rate of return must be the highest possible is not necessarily in the best interest of plan participants and beneficiaries and may be a substantial detriment in many cases. Plan trustees should have the clear authority to consider all relevant economic factors in investing the plan assets.

Let me illustrate this point with an example using a single-employer defined benefit pension plan of an employer whose business is related (as many are) to the residential construction industry. For actuarial purposes the plan needs to achieve at least a six percent return on its investment, a common actuarial investment assumption, even in today's markets. Due to declines in the stock market, the plan's average rate of return is currently 10 percent. This also is not an uncommon experience in today's market.

The trustees could achieve a higher rate of return than they are currently achieving, make an investment that is more secure than their typical investment, benefit the plan participants by helping to secure their jobs and therefore their pensions, and benefit the local economy, if they were to invest in residential mortgages. Even if the plan were to invest in residential mortgage at a rate of 12 percent, when the so-called market rate is in excess of 16 percent, the plan would achieve a better rate of return than it is currently achieving. By investing at that rate, home sales would be stimulated and local employment and pensions better secured. Further, because the plan is well funded and the actuarial assumptions only require a six percent rate of return, the difference in investment return between obtaining 12 percent and obtaining 16 percent does not have <u>any</u> effect on the pensions that will be received by the participants.

As this example illustrates, the straightjacket of having to obtain the highest possible rate of return on a mortgage investment -- rather than obtaining a reasonable or prudent return in light of all the economic circumstances -- can be a substantial detriment to the participants and beneficiaries. A reduction in the rate of earnings may have a beneficial effect in securing jobs and pensions, factors that should be relevant to the trustees' investment decision. Nevertheless, under the Department of Labor's interpretation of the prudent man rule of ERISA, the trustees must seek a 16 percent rate of return if that is the going "market" rate. While the Labor Department routinely denies that it directs plan investments, the net effect of its policies is to control plan investments. We do not believe Congress intended the Labor Department to function in that capacity.

Further, it should be pointed out that the current high mortgage rates do not reflect a true arm's-length rate. The high interest rates have been established by lenders who are unwilling to make long-term mortgages in the financially uncertain markets that currently exist. The decline in the homebuilding industry clearly reflects the fact that there is a substantial unwillingness or inability on the part of home purchasers to pay these high interest rates. Consequently current rates do not reflect a normal market, but rather an aberrational market in which the lenders are artificially increasing the interest rate to forestall making mortgage loans. We therefore question whether the current interest rate could even be recognized as a fair market rate. Further, mortgage loans typically are subject to a range of rates depending on their terms and other factors. As a result, it is always difficult to accurately determine a "market" rate.

As these problems point out, the Exemption from the Department of Labor does not sufficiently authorize plan trustees to make mortgage investments. We believe that only Congress can provide the necessary relief by rewriting some of the overly strict provisions that were incorporated in ERISA in 1974.

B. Legislative Relief

Given the problems outlined above, there is a clear, immediate and urgent need for Congress to enact legislation that will remove the artificial barriers that effectively block plan trustees from investing in mortgages. The legislation should remove the second class investment status that has been assigned to mortgages. The mortgages that plan trustees acquire should not be circumscribed to a particular class of mortgages, but rather the trustees should be free to acquire any mortgage that they feel are financially sound. If trustees feel that mortgages other than those outlined in the Exemption are suitable investments, just as if the trustees wish to acquire stock other than blue chip securities, the trustees should be free to do so in their best judgment. Further, under ERISA the trustees are given the responsibility and authority to direct and control the investment of plan assets. The trustees should also have this responsibility for mortgage investments, thereby avoiding the added expense and burden of having to retain an outside specialist to make one class of plan investments.

All of these changes should be made in a way that will streamline the ability of plan trustees to make investments into residential mortgages. Just as there is no need for added layers of protection to guard against plan trustees abusing their authority when they purchase securities, bonds or other corporate instruments, there should be no need for artificial restrictions and burdens for plan trustees that wish to invest in residential mortgages.

NAHB requests that this Subcommittee immediately take action to develop legislation that will accomplish these goals. We believe a wide variety of approaches are possible to solving these problems but stress that immediate action should be taken because of the critical nature of the housing industry at the present time. We note that one bill has been introduced that we believe would provide substantial relief and would accomplish the goals just outlined.

S.1678, introduced by Senator Hatch on September 29, 1981, would eliminate the prohibited transaction restrictions on mortgage investments and provide mortgage investments with a safe harbor from the prudent man rule. By adding a statutory exemption to section 408, the bill, if enacted, would remove the risk of prohibited transaction treatment for plan investments in home mortgages.

Specifically, the bill requires that investment in home mortgages be authorized by the express terms of the plan, that normal commercial standards apply to the terms of the mortgages, and that the interest rate charged to a borrower satisfy one of three alternative standards designed to insure that the rate is adequate. NAHB believes that these standards, in conjunction with the prohibition against fiduciary self-dealing in section 406(b) of ERISA and the penalties under the Internal Revenue Code, are more than adequate to protect plans and plan participants from any wrongdoing that may potentially exist in situations where transactions occur between plans and parties in interest.

IV. Conclusion

NAHB commends the the Department of Labor for its efforts in providing a more workable exemption for plan investments in residential mortgages. The final Exemption represents a major improvement over the proposed exemption issued last December.

As outlined above, however, there are still major problems not solved by the Exemption and there is an immediate and urgent need for a legislative solution. NAHB is ready, willing and able to provide any necessary assistance in the development of appropriate legislation.

SELECTED INTEREST RATES AND YIELDS, 1970-80

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1970-1980 Aver.	1975-1980 Aver.
6 Month T-Bill, Secondary mkt.	6.51%	4.52%	4.49%	7.20%	7.95%	6.11%	5.26%	5.53%	7.58%	10.06%	11.37%	6.96%	7.65%
12 Month T-Bill, Secondary mkt.	6.49	4.67	4.77	7.01	7.71	6.30	5.52	5.71	7.74	9.75	10.89	6.96	7.65
Moody Aaa	6.12	5.22	5.04	4.99	5.89	6.42	5.66	5.20	5.52	5.92	7.85	5.80	6.10
Moody Baa	6.75	5.89	5.60	5.49	6.53	7.62	7.49	6.12	6.27	6.73	9.01	6.68	7.21
20 Year Treasury Bonds	-	-	-	-	8.05	8.19	7.86	7.67	8.48	9.33	11.39	-	8.82
30 Year Treasury Bonds	-	-	-	-	-	-	-	-	8.49	9.29	11.30	-	-
Dividend/Price Ratio													
Preferred Stocks	7.22	6.75	7.27	7.23	8.21	8.38	7.97	7.60	8.25	9.07	10.57	8.05	8.64
Common Stocks	3.83	3.14	2.84	3.06	4.47	4.31	3.77	4.56	5.28	5.46	5.25	4.18	4.77
FNMA Auctions													
Government Underwritten Loans	9.00	7.82	7.64	8.33	9.31	9.26	8.99	8.73	9.71	11.50	14.15	9.49	10.39
Conventional Loans	-	-	7.82	8.53	9.43	9.37	9.11	9.05	10.01	11.77	14.43	-	10.62
FHLBB Effective Rate													
Newly Built Homes	8.45	7.74	7.60	7.96	8.93	9.02	9.00	9.01	9.54	10.77	12.65	9.15	10.00
Previously Occupied Homes	8.36	7.67	7.51	8.02	9.04	9.21	9.11	9.02	9.58	10.92	12.95	9.22	10.13
All Homes	8.38	7.69	7.53	8.00	9.00	9.16	9.08	9.02	9.56	10.87	12.86	9.20	10.09

Source: Federal Reserve Board. Federal National Mortgage Association. Federal Home Loan Bank Board

MORTGAGES AS AN INVESTMENT

Over the 1970s, home mortgage interest rates have generally been higher than interest rates in the money and capital markets. Between 1970 and 1980, the Federal Home Loan Bank Board's conventional mortgage rates for newly built and previously occupied homes averaged 9.2 percent, and FNMA yields on government underwritten loans were about 9.5 percent. Over the same period, both six-month and twelve-month Treasury Bills in the secondary market yielded slightly less than 7 percent, Moody's Baa bonds yielded about 6.7 percent, and Moody's Aaa bonds yielded 5.8 percent. The dividend/price ratio for preferred stocks was slightly more than 8 percent, while common stocks were at a meager 4.18 percent.

The same basic relationships exist if one examines the 1975-1980 period, except that all the rates are slightly higher. Also, twenty-year Treasury Bonds were between 100 and 200 basis points lower than the mortgage rates in the primary and secondary markets during this period; and in the secondary market, conventional loans had yields 33 basis points higher than government loans at FNMA auctions.

All in all, home mortgage rates compare very favorably to interest rates on various types of investments.

STATEMENT OF DOUGLAS E. JOHNSON, VICE PRESIDENT, CHASE HOME MORTGAGE CO., MONTVALE, N.J., ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Senator CHAFEE. Mr. Johnson.

Mr. JOHNSON. Mr. Chairman, I am Douglas Johnson. I am a vice president of the Chase Home Mortgage Co. of Montvale, N.J., a subsidiary of the Chase Manhattan Corp. I am testifying today in my capacity as chairman of the New Investor Opportunities Subcommittee of the Mortgage Bankers Association of America. Appearing with me is William E. Cumberland, MBA's general counsel.

We appreciate the opportunity to appear before you to testify on the desirability of pension fund investment in mortgages and on the impediments to such investments that are imposed by the Employees Retirement Income Security Act (ERISA). ERISA has had the effect of inhibiting pension plan trustees and pension plan managers for making investments in mortgages, mortgage backed securities, and other forms of real estate assets that can provide attractive returns for pension funds and provide the diversity that prudent investing and ERISA require.

The structure of ERISA interferes with pension fund investment in both commercial real estate and residential properties. Because the housing industry is in a dire economic condition and has immense potential needs for financing, pension investment in residential property has received special attention from the administration and the Department of Labor. On May 14, the Department of Labor made public a series of rulings affecting pension plan investments in residential mortgages. The Department of Labor was responding to a request for a class exemption for mortgages submitted to them in 1980, and to repeated requests of labor and industry, as well as the President's Housing Commission and from President Reagan himself. Two of the rulings are class exemptions and the third is a final interpretive regulation defining the term "plan assets" in the context of mortgage backed securities and other mortgage pools of home mortgages.

There has been little time to study the ramifications of these rulings. And most important, the real estate finance market has had no opportunity to try to operate under them.

However, unless some unrecognized factors emerge, the rulings appear to be a giant step on the way toward freeing up pension funds for investment in mortgages on newly constructed and also on existing homes. MBA and the mortgage banking industry applaud the Department for attentive and earnest efforts to develop a rule under which the market can function in a healthy manner.

When the DOL published prohibitive transaction exemption 81-7 last summer; proposed whole loan exemption last December, MBA commented extensively, suggesting that each of these exemptions be broadened in recognition of the market. Almost every suggestion that MBA made was responded to favorably by the Department of Labor in the rules made available May 14 for publication in the May 18, 1982 Federal Register. As published, the new exemptions and the definition of "plan assets" would appear to allow pension fund managers to enter into the mainstream of residential mortgage investment to the benefit of the pension plans and to the benefit of the housing market and housing industry.

As recognized by the DOL, these rulings do not remove all the barriers to sound investment by pension plans in real estate. The categories of commercial and industrial properties are not covered. Multifamily residential projects, which are increasingly recognized as a very efficient form of housing, are expressly excluded. These types of real estate are providing attractive returns on investments for other institutional investors and pension plans should be allowed similar investment opportunities. The new rules also saddle mortgage investment with the mandatory cost of hiring a real estate investment adviser, even where the trustees, themselves, are very knowledgeable.

In both the whole mortgage exemption and the plan asset rule, the DOL has adopted the mortgage standards of FNMA, FHLMC, or the Government National Mortgage Association. All of these institutions were created by Federal statute. And each was created for a purpose other than defining what mortgage investments for pension funds should be. Whether the standards they have developed to accomplish their purposes will serve pension plans fully remains to be seen.

In fact, there are mortgages that are not purchased by Freddy Mac or Fannie Mae and that are very popular with the public pension funds, which have not been regulated by ERISA. For example there is something called the "price level adjusted mortgage" which has been used in the west for investment by public pension funds. This is just one example of the sort of thing that MBA is concerned about not being covered by the exemption.

[The prepared statement follows:]

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Washington, D.C. 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

DOUGLAS E. JOHNSON

VICE PRESIDENT
CHASE HOME MORTGAGE COMPANY
MONTVALE, NEW JERSEY

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

of the

COMMITTEE ON FINANCE

UNITED STATES SENATE

Hearings on

The Employees Retirement Income Security Act

May 19, 1982

Mr. Chairman and Members of the Subcommittee, my name is Douglas E. Johnson. I am Vice President of Chase Home Mortgage Company, of Montvale, New Jersey. I am testifying today in my capacity as Chairman of the New Investor Opportunities Subcommittee of the Mortgage Bankers Association of America.* Appearing with me is William E. Cumberland, MBA's General Counsel.

We appreciate the opportunity to appear before you to testify on the desirability of pension fund investment in mortgages, and on the impediments to such investments that are imposed by the Employees Retirement Income Security Act (ERISA). ERISA has had the effect of inhibiting pension plan trustees and pension plan managers from making investments in mortgages, mortgage-backed securities, and other forms of real estate assets that can provide attractive returns for pension funds and provide the diversity that prudent investing and ERISA require.

The structure of ERISA interferes with pension fund investment in both commercial real estate and residential properties. Because the housing industry is in a dire economic condition and has immense potential needs for financing, pension investment in residential property has received special attention by the Administration and the Department of

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance companies
- Life Insurance companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

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Labor. On May 14, the Department of Labor (DOL) made public a series of rulings affecting pension plan investment in residential mortgages. DOL was responding to a request for a class exemption for mortgages submitted to them in 1980, and to repeated requests of labor and industry, as well as the President's Housing Commission and President Reagan himself. Two of the rulings are class exemptions from the prohibited transactions provisions of ERISA. The third is a final interpretive regulation defining the term "plan assets" in the context of mortgage backed securities and other mortgage pools of home mortgages.

There has been little time to study the ramifications of these rulings, and, most important, the real estate finance market has had no opportunity to try to operate under them.

However, unless some unrecognized factor emerges, the rulings appear to be a giant step on the way toward freeing up pension funds for investment in mortgages on newly constructed and also on already existing houses. MBA and the mortgage banking industry applaud the Department for attentive and earnest efforts to develop a rule under which the market can function in a healthy manner.

Fundamental changes that are occurring in the way housing is financed in this country should present new investment opportunities for pension funds. A combination of factors has severely reduced the effectiveness of the old mortgage finance system which relied heavily on mortgage investment by savings and loans and other thrift institutions. While in the future, thrifts may specialize in consumer and/or real estate lending, they will not hold long-term loans, such as mortgages, in portfolio to the extent they have in the past. This will create a home financing gap. Mortgages must be packaged and sold to pension funds and others with sources of long-term funds in order to fill that gap.

The demand for housing that is expected to occur in the 1980s will require a tremendous amount of capital. At the end of 1980, outstanding mortgage debt in the United States stood at $1.1 trillion. By 1990, that amount is expected to triple. Raising this volume of funds will require that mortgages be attractive to those who make long-term capital investments, such as pension trustees and managers.

Pension funds control an increasing share of American capital and so, must be tapped if sufficient funds are to be made available to housing. In addition, because they consist of stable long-term funds with an obligation to pay an annuity in the future, pension funds are ideally suited to mortgage investment. Public pension funds, i.e., those serving state and local government employees, are becoming increasingly important investors in residential mortgages. The Federal Reserve Board reports that such funds made net mortgage investments of $190 million in 1976, $679 million in 1978, and $1.3 billion in 1980. However, private pension fund investment has been so small as to be virtually non-existent. This lack of investment on the past of private funds can be traced largely to the inhibiting effects of ERISA, MBA believes.

When the Department of Labor (DOL) published Prohibited Transaction Exemption 81-7 last summer, and the proposed whole loan exemption last December, MBA commented extensively, suggesting that each of these exemptions be broadened in recognition of the market. Almost every suggestion MBA made was responded to favorably by DOL in the rules made available May 14, for publication in the May 18, 1982 Federal Register. As published, the new exemptions and the new definition of "plan assets" would appear to allow pension fund managers to enter into the mainstream of residential mortgage investment to the benefit of the pension plans and to the benefit of the housing market and the housing industry.

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As recognized by the DOL, these rulings do not remove all the barriers to sound investment by pension plans in real estate. The catagories of commercial and industrial properties are not covered. Multi-family residential projects, which are increasingly recognized as an efficient form of housing, are expressedly excluded. These types of real estate are providing attractive returns on investment for other institutional investors, and pension plans should be allowed similar investment opportunity. The new rules also saddle mortgage investment with the mandatory cost of hiring a real estate investment advisor, even where the trustees are themselves knowledgable.

In both the whole mortgage exemption and the "plan asset" rule, the DOL has adopted the mortgage standards of the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). All of these are created by Federal statute, and each was created for a purpose other than defining what types of mortgage investments pension plans should be making. FNMA and FHLMC are intended to support the secondary market for mortgages for moderate- and middle-income homebuyers, traditionally by purchasing such mortgages when the market requires, and just recently, by guaranteeing securities based on and backed by such mortgages. Each has limits on the dollar amount of any individual mortgage they may purchase. For example FNMA may not buy a mortgage with a principal balance of more than $107,000. They also have aggregate dollar activity limits controlled by Federal government officials. GNMA is a part of the Department of Housing and Urban Development which currently buys only below-market interest rate multi-family mortgages and guarantees securities based on and backed by mortgages insured or guaranteed by other Federal agencies whose programs are determined by social, as well as market need. There is no question that these instrumentalities have proven themselves knowledgeable and successful in the mortgage markets. Whether the standards they have developed to accomplish their purpose will serve pension plans fully as to home mortgage investment remains to be seen.

In order to assist the Committee in evaluating the favorable effect of the rules published by DOL, and in understanding the problems presented by ERISA, the following explanation of the relationship of ERISA and the real estate finance market might be helpful.

ERISA PROVISIONS

ERISA was enacted in response to well-documented and well-publicized abuses of their powers by trustees and others in positions to direct the use of pension plan assets. In establishing a nationwide, explicit test of fiduciary duty, and clarifying who are fiduciaries subject to the test, ERISA has worked well to encourage widespread responsibility in the pension field. These standards, especially the "prudent man" rule, were an incorporation of a variety of related standards that had been developed and tried over the years in the common law of the several states.

ERISA also introduced a novel approach to protecting pension beneficiaries from self-dealing and favoritism by those in positions to direct the use of plan assets. The "prohibited transactions" section of ERISA, Section 406 (29 U.S.C. 1106), has little legislative history and no widely used and developed antecedents. This section provides:

"PROHIBITED TRANSACTIONS"

"Sec. 406. (a) Except as provided in section 408:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;
(B) lending of money or other extension of credit between the plan and a party in interest;
(C) furnishing of goods, services, or facilities between the plan and a party in interest;
(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a)

(b) A fiduciary with respect to a plan shall not—
(1) deal with the assets of the plan in his own interest or for his own account,
(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

(c) A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer.

The general fiduciary duty approach of the Act rests on the assumption that pension managers can and should perform their trust by exercising their sound judgment in the best interests of the pension plan. In contrast, the prohibited transaction approach rests on the assumption that pension managers cannot and should not perform their trust by exercising their sound judgment in the best interests of the pension fund. It specifically prevents that exercise in a broad range of circumstances. The transactions prohibited by Section

406 are categorical and are not permitted by the Act, even if they would otherwise be in the best interests of the pension fund, or are routinely performed by other asset managers.

It is this observation that is so frustrating for those involved in home finance. The mortgage market is well established and active. It is a market that allows an investor or a pension plan trustee to measure the prudence of an investment against the investment decisions of other experienced investors. Yet ERISA effectively interferes with pension fund involvement in both the financing of new construction and in the financing of the purchase of existing, or older buildings.

MORTGAGE MARKETS

Financing for real estate building projects generally occurs in two phases: short-term loans to the project developer to pay for the cost of construction; and long-term loans to the purchasers of residential units or owners of the income property, the proceeds of which are used to pay for the property. The developer pays off the short-term construction loan with the proceeds of the sales of the housing or with the "permanent" financing of the income property project.

Before a lender will make a construction loan, it must be satisfied that long-term financing will be available when the construction is completed. Generally, such a lender, if it does not intend to provide the long-term financing itself, will require a commitment from another lender obligating the second lender to make such long-term financing available. Once a satisfactory commitment has been obtained, the construction loan will be made.

Often a developer seeking a short-term construction loan will contact a company that specializes in obtaining commitments for long-term financing—a mortgage banker. The mortgage banker first makes a determination as to the feasibility of the proposed project. If that determination is favorable, the mortgage banker will agree to attempt to obtain a commitment for long-term financing. The mortgage banker usually looks to financial institutions or institutional investors.

The investor usually issues a written commitment to provide long-term financing or to buy mortgages from a mortgage banker and, after the building is completed, makes long-term loans to purchasers of the housing units, or takes into portfolio the financing originated by the mortgage banker. Long-term investors include insurance companies, commercial and mutual savings banks, savings and loan associations, and the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), the two federally chartered instrumentalities whose purpose is to support an orderly mortgage market and pension funds. A commitment is made for a specific time period, and a fee is usually charged by the investor.

Under a typical commitment, an investor obligates itself to provide a specific amount of long-term loans to purchasers of dwelling units or owners of income producing property who qualify under the investor's mortgage loan guidelines. In a case where the mortgage banker makes the commitment to provide long-term financing, the investor will obligate itself to purchase a specific amount of mortgages originated by the mortgage banker, provided that those mortgages meet the guidelines. The terms of the loans, such as the amortization period, the rate of interest, the percentage of value loaned, the requirements for loan qualification, the credit worthiness of the borrower, inflation hedges and the quality of the security, are set by the investor.

Usually, when an investor buys mortgages from the mortgage banker, the investor leaves with the mortgage banker the responsibility for collecting the monthly payments from the owner/borrower, paying real estate taxes and hazard insurance premiums, and otherwise administering the loan. This function is performed for a fee and is called "servicing." Servicing fees are an important source of income for mortgage bankers.

The above explanation describes two markets for long-term mortgages. The market in which the homebuyer or income property owner obtains a mortgage loan, whether directly from an investor or from a mortgage banker, is called the "primary market".

The sale of the mortgage to an investor occurs in what is called the "secondary market." The secondary market also operates in a similar way to finance the purchase of existing, or older, housing or other buildings. No construction loan is involved, of course, and the length of time a commitment to purchase the mortgages is outstanding is generally shorter. In fact, mortgage bankers sometimes agree to originate mortgages on existing housing without having a commitment from an investor, taking a chance that the mortgage can be sold after it is originated.

A variation on this basic way in which mortgage investors acquire mortgages as assets is the rapidly expanding market for securities issued by mortgage bankers and other loan originators based on a collection, or pool, of mortgages originated or otherwise obtained by the issuer. The most popular of these mortgage-backed securities are in the housing finance aspect of the market. These have scheduled payments of principal and interest that are guaranteed by the Government National Mortgage Association (GNMA) a part of the Department of Housing and Urban Development (HUD). The mortgage-backed security device allows an investor to own a small portion of a large number of mortgages and thereby diversify risk and simplify accounting. Mortgage-backed securities are also generally more liquid than whole mortgages, that is, mortgages that are not part of a pool whose ownership is shared by several investors.

ERISA BARRIERS

If a pension fund wanted to be an investor in the mortgage markets as they now function, a violation of one or more of the prohibited transactions provisions of ERISA might arise due to a possible relationship between a pension fund and certain parties involved in the transactions. Fitting the definition of party in interest in Section (3)(14) of ERISA would be: a mortgage banker or other loan originator who is providing loan administration services on loans previously originated or purchased by the plan (a servicing mortgage banker); a developer of a project or a builder involved in the construction of the dwelling units who employs persons covered by a multi-employer plan; and an individual seeking a loan in order to purchase a dwelling unit may be party in interest under, among others, Section (3)(14)(H) of the Act, by reason of being an employee of an employer, a service provider, or a union that is related to the plan.

Therefore, possible violations may arise in several phases of the above described transactions: The exchange of a loan commitment for a loan fee between a pension fund and a servicing mortgage banker may give rise to a violation of section 406 (a)(1)(A) and (D) of the Act. A commitment by a pension fund to make loans or purchase mortgages, the proceeds of which will be used to purchase units developed and/or to be built, in whole or in part, by a contributing employer with respect to the fund, might arguably give rise to a violation of section 406 (a)(1)(B) and (D) of the Act. It shculd be noted, in this respect, that the Department of Labor has expressed its view that a transaction involving similar possible violations; i.e., the provision of a construction loan by a plan to an unrelated party who contracts with a contributing employer to do the construction, would not, in itself, constitute a prohibited transaction under section 406 (a) of the Act. If, in the case described in (ii) above, the employer is a fiduciary with respect to the fund, the mere involvement of the employer as a developer or builder might, in itself, be characterized as a technical violation of section 406(b)(2) of the Act.

The purchase of a mortgage by a fund from a servicing mortgage banker, or a direct loan by a fund, the proceeds of which loan are used to purchase a dwelling unit, which purchase results in the repayment, in whole or in part, of a construction loan to a servicing mortgage banker, might give rise to a violation of section 406 (a)(1)(A) and (D) of the Act. If the proceeds of a direct loan or a loan purchased by a pension fund are used to purchase a unit developed and/or built, in whole or in part, by a contributing employer, such loan or purchase might be characterized as a violation of section 406 (a)(1)(D) of the Act. A direct or indirect (through the purchase of a mortgage) loan by a pension fund to a purchaser of a dwelling unit who is an employee of a contributing employer, service provider, or related union might give rise to a violation of section 406 (a)(1)(B) and (D) of the Act. Although section 408 (b)(1) of the Act may provide an exemption for such loans from a plan to persons who are participants and beneficiaries with respect to the plan, there is no relief for such loans to employees of service providers or unions that are related to the plan. The provision of additional loan administration services by a servicing mortgage banker might give rise to a violation of section 406 (a)(1)(C) and (D) of the Act. However, the statutory exemption provided in section 408 (b)(2) of the Act appears to permit such transactions.

This list is, by no means, intended to be exhaustive. It is illustrative of the problems and dangers pension fund managers face if they try to enter the mortgage market. The effect is to inhibit the entry of pension funds into the area of real estate finance.

EXEMPTION RELIEF

The mechanism ERISA establishes for providing relief from the prohibited transaction rule where it is overly restrictive has not worked efficiently for real estate finance in the past. Under Section 408 of the Act (29 USC 1108), the Secretary of Labor has had authority to grant exemptions for classes of fiduciaries or classes of transactions since 1975. Until last week, the Secretary had issued one class exemption with regard to home mortgage-backed securities (Prohibited Transaction Class Exemption 81-7, January 18, 1981) and had proposed for comment a class exemption for mortgages on new houses. (46 Fed. Reg. 58773, Dec. 3, 1981).

The class exemption regarding certain mortgage-backed securities was welcomed by the housing finance industry. The exemption allowed, under specified conditions, transactions between plans and parties in interest involved in the origination, servicing, and administration of certain types of mortgage pool investment trusts and the acquisition by plans of certain mortgage-backed securities. It did not address all types of mortgage pools and mortgage-backed securities, however, and it took several years and substantial expense to have the Department issue the exemption.

While the Department of Labor was considering its rule, which cleared the basic immediate purchase and sale of securities backed by first lien mortgages, the market was developing more sophisticated variations that offer better investment opportunities. The rule issued May 14 by DOL amending Class Exemption 81-7 responds to the later market developments.

The exemption for mortgages or newly constructed housing had serious flaws, most of which are covered by DOL in the introductory explanation of the new exemption. The defects were pointed out to DOL and it correct its proposed ruling accordingly. The significance of the defects, however, was not removed by making the corrections. The defects in the home mortgage proposal, the omissions in the mortgage-backed security exemption, and the time and the expense incurred to produce each of these inadequate rulings demonstrated the failure of the prohibited transaction exemption mechanism now in ERISA, as interpreted by the Department of Labor, to encourage pension plan investment in the highly sophisticated and rapidly developing real estate finance market.

DOL has now proposed to solve the problem of ERISA, at least for home mortgages, by deferring to the expertise of other government instruments, rather than to the market. We hope the effort is successful.

MBA appreciates the opportunity to appear before the Subcommitte and would be happy to furnish any additional information if needed.

Senator CHAFEE. Are the public pension funds substantially invested in home mortgages?

Mr. JOHNSON. Sir, I can tell you that I personally have placed pools of mortgages with public pension funds. In fact, the statistics show that in 1980, they did $1,300,000 in investment. And the volume it is even larger in 1981. The statistics just aren't available yet.

We believe in the MBA that one of the major reasons that private funds have not been in this market is because of ERISA and its restrictions which now have been abrogated to a great extent.

Senator CHAFEE. Why do you believe that in that new rule that they have issued they don't have a multifamily housing decision in there?

Mr. CARL. Mr. Chairman, I think multifamily housing involves a different kind of credit risk than a single family house. The credit risk in multifamily housing is the success or failure of a business rather than the credit risk posed by an individual's income and his ability to meet his mortgage payments. I think the problem is that multifamily housing is simply a much more complex area. And the Labor Department, I am sure, is requiring more time in order to analyze what the reasonable credit risks are to be included in the regulations.

Senator CHAFEE. Do you agree with that Mr. Johnson?

Mr. JOHNSON. I think that is probably a fair assessment of the Department's reasoning.

Senator CHAFEE. Dr. Carlson, you are an economist. And I think we are agreed here that we don't want to mandate *x* amount of the pension funds being invested in housing. So absent that, do you really think there is much of a potential for providing any substantial relief, any recognizable relief to the housing industry from the pension funds?

Dr. CARLSON. In terms of access to funds available in our economy, yes. The representative from the Housing Commission indicated 2 percent to 3 percent is the estimate of pension funds investment in residential mortgages. If you look at where savings go in this economy, it's about 25 percent. Obviously, there has been a reason why 2 to 3 percent has existed when the average is 25 percent. And clearly these barriers, I think, have kept funds out of there.

In terms of bringing down the interest rate, however, I do not think we should hold out too much help there. By perfecting the market, you can have some modest interest rate drop. But clearly, the drop in interest rates to allow affordability of housing in this country has to appear with other policies; not this policy.

Senator CHAFEE. All right. Thank you all very much for appearing. We appreciate it.

Now the final panel on this, before we get to 1910, is Mr. Moore, Mr. O'Brien, and Mr. Hobgood.

All right, Mr. Moore, why don't you proceed?

STATEMENT OF T. JERALD MOORE, VICE PRESIDENT, AETNA LIFE INSURANCE CO., HARTFORD, CONN., ON BEHALF OF AMERICAN COUNCIL OF LIFE INSURANCE, WASHINGTON, D.C.

Mr. MOORE. My name is Jerald Moore and I am a vice president with the Aetna Life Insurance Co. in Hartford, Conn. I am responsible for marketing pension investment services.

I appear today on behalf of the American Council of Life Insurance, a national trade association with a membership of 524 companies, which account for 96 percent of the legal reserve life insurance in force, and 99 percent of the insured pension business in the United States.

At the end of 1981, total assets of the life insurance business exceeded $520 billion and the funds held on behalf of employee benefit plans and pension accounts totaled $180 billion. We are pleased to have this opportunity to present the views of our business on the question of using pension funds in support of the home mortgage market.

When the Employee Retirement Income Security Act was enacted in 1974, Congress deliberately and knowingly established certain standards of prudent investment as a means of enhancing and protecting the retirement security for plan participants. The American Council of Life Insurance has supported these standards as a necessary element of sound practice, and necessary safeguards for the people whose money we are managing.

However, there have been provisions in ERISA that unnecessarily and artificially restricted the investment of pension funds in real estate generally, and are particularly burdensome when applied to residential mortgage investments. They discouraged plans from making residential mortgage investments even when those investments were arm's length and prudent. We have recommended that this problem be dealt with as soon as possible. And we are anxious to review the exemptions that were discussed in earlier testimony.

While some progress has been made in this area, we believe more could be made. And, we hope to encourage continued dealings with problems we have encountered.

Senator CHAFEE. Mr. Moore, what principally was the inhibiting factors? Was it the prohibited transaction rule?

Mr. MOORE. Yes.

Senator CHAFEE. That's it? In other words, you might scoop up the mortgage of one of your officers or employees or something like that?

Mr. MOORE. It could be. We were prohibited—we had to review in advance possible parties in interest. And there could be in some examples, hundreds of thousands of parties in interest in certain large pension funds. And it was simply impossible to monitor that in advance.

Senator CHAFEE. Now they have changed that.

Mr. MOORE. They have changed that. And I would like to say we have not had a chance to review the changes and the exemptions. And we hope that will assist us in reviewing this again.

There are several other points however. There have been many occasions in which we have been tempted to use pension funds' investments for purposes other than the plan participants. And such proposals are often designed to serve social purposes, as opposed to the financial purpose of providing security to the plan participants. In our view, the prudent standards set forth by ERISA should not be compromised in order to accommodate the goals of social investment or to stimulate the flow of funds to favored sectors of the credit market.

There are two very important reasons for this point of view. First, directing pension money into designated areas that lack normal market appeal means that the investor takes a higher risk or accepts a lower yield than would be available from other forms of investment. Such directed investments for these purposes involve a concealed subsidy from the lender to the borrower, and this subsidy is ultimately borne by those who receive retirement benefits from the pension plan.

Second, funds channeled into a favored sector such as the home market can only be provided at the expense of some other investment sector which could be deprived of financing. These other sectors could include funds needed for new plant expansion, technological improvements in production methods or financing small and growing business firms.

It must be recognized that these forms of financing also serve highly important economic and social needs of our Nation, and great care should be taken in rechanneling funds away from such needs. This situation is even more striking if the directed investments into certain areas are to be loaned at below market interest rates, as has been suggested in recent proposals.

The basic question is this: Should beneficiaries of pensions plans, a group which includes low income individuals, be called upon to provide subsidies to those seeking to borrow money in the home mortgage market. And that group would include individuals with higher incomes. This question which might fairly be viewed as an upward redistribution of capital in many cases, must be weighed carefully before a decision is made to interfere with market relationships.

But as a concluding comment, let me point out that our social priorities tend to change over time. And all of us in this room can recall when those heading the ever-changing list were energy, inner-city development and local government financing. Obviously, each of these priorities is worthy of our continuing concern and best efforts. We submit, however, that retirement income is a problem of equal significance, especially in view of the state of social security. Proposed legislation which would in any way compromise the level and security of retirement income should be, in our opinion, very carefully considered and balanced against competing priorities before implementation.

Senator CHAFEE. Well, I agree with you on that. But now that the special interest exemption—you haven't had a chance to study it. Apparently it is doing what you thought of. Do you have any other suggestions?

Mr. MOORE. I think that was the main change we were looking forward to receiving. And we are anxious to review it in detail. And perhaps it does create an opportunity we have simply not had in the past.

Senator CHAFEE. But was that the reason you didn't go into it as a manager of pension funds?

Mr. MOORE. That was the reason that pension funds did not elect to direct their investments into some managed fund of maybe pooled home mortgages. Yes.

Senator CHAFEE. Now what about the suggestion that was made by Mr. Carl that multifamily houses be included. Does that tempt you or would you find that for business reasons you wouldn't? That's a business rather than the responsibility of an individual. Would you tend to shy away from multifamily housing?

Mr. MOORE. I think we would automatically tend to shy away. As Mr. Carl mentioned, that would complicate the procedure somewhat. But we would view that as an opportunity if the exemption were extended to the multifamily.

[The prepared statement follows:]

Statement by the
American Council of Life Insurance
before the
Subcommittee on Savings, Pensions and Investment Policy
of the
Senate Finance Committee
May 19, 1982

My name is T. Jerald Moore and I am a Vice President of Aetna Life Insurance Company of Hartford, Connecticut, responsible for marketing pension investment services. I appear today on behalf of the American Council of Life Insurance, a national trade association with a membership of 524 companies which account for 96 percent of the legal reserve life insurance in force and 99 percent of the insured pension business in the United States. At the end of 1981, total assets of the life insurance business exceeded $520 billion and the funds held on behalf of pension accounts and other employee benefit plans totaled $180 billion. We are pleased to have this opportunity to present the views of our business on the question of using pension funds in support of the home mortgage market.

When the Employee Retirement Income Security Act was enacted in 1974, Congress deliberately and knowingly established certain standards of prudent ~~investment as~~ a means of enhancing and protecting the retirement security for plan participants. The American Council of Life Insurance has supported these standards as a necessary element of sound practice and necessary safeguards for the people whose money we are managing.

HOWEVER, THERE HAVE BEEN PROHIBITIONS IN ERISA THAT UNNECESSARILY AND ARTIFICIALLY RESTRICTED THE INVESTMENT OF PENSION FUNDS IN REAL ESTATE GENERALLY AND ARE PARTICULARLY BURDENSOME WHEN APPLIED TO RESIDENTIAL MORTGAGE INVESTMENTS. THEY DISCOURAGED PLANS FROM MAKING RESIDENTIAL MORTGAGE INVESTMENTS EVEN WHEN THOSE INVESTMENTS WERE ARMS LENGTH AND PRUDENT. WE HAVE RECOMMENDED THAT THIS PROBLEM BE DEALT WITH AS QUICKLY AS POSSIBLE AND ARE ANXIOUS TO REVIEW THE NEW EXEMPTIONS DISCUSSED IN EARLIER TESTIMONY. WHILE SOME PROGRESS HAS BEEN MADE IN THIS AREA, MORE NEEDS TO BE DONE TO DEAL WITH THE PROBLEMS WE HAVE ENCOUNTERED. WE WILL CONTINUE TO STRONGLY SUPPORT EFFORTS TO RESOLVE THIS PROBLEM IN A MANNER THAT WILL ENCOURAGE RESIDENTIAL MORTGAGE INVESTMENTS WITHOUT CREATING A BIAS IN FAVOR OR THOSE INVESTMENTS BY DIMINISHING THE PRUDENCE REQUIREMENTS OF ERISA.

SINCE ENORMOUS AMOUNTS OF INVESTMENT DOLLARS ARE INVOLVED, THERE HAVE BEEN OCCASIONS IN WHICH THE TEMPTATION HAS ARISEN TO CHANNEL PART OF THESE FUNDS INTO INVESTMENT FORMS THAT WOULD NOT ORIDINARILY BE ATTRACTIVE ON A MARKET BASIS. SUCH PROPOSALS ARE OFTEN DESIGNED TO SERVE SOCIAL PURPOSES, AS OPPOSED TO THE FINANCIAL PURPOSE OF PROVIDING SECURITY TO PLAN PARTICIPANTS. IN OUR VIEW, THE PRUDENCE STANDARDS SET FORTH BY ERISA SHOULD NOT BE COMPROMISED IN ORDER TO ACCOMMODATE THE GOALS OF SOCIAL INVESTMENT, OR TO STIMULATE THE FLOW OF FUNDS TO FAVORED SECTORS OF THE CREDIT MARKET.

THERE ARE TWO VERY IMPORTANT REASONS FOR THIS POINT OF VIEW. FIRST, DIRECTING PENSION MONEY INTO DESIGNATED SECTORS THAT LACK NORMAL MARKET APPEAL MEANS THAT THE INVESTOR TAKES A HIGHER RISK OR

ACCEPTS A LOWER YIELD THAN WOULD BE AVAILABLE FROM OTHER FORMS OF INVESTMENT. SUCH DIRECTED INVESTMENTS FOR SOCIAL PURPOSES INVOLVE A CONCEALED SUBSIDY FROM THE LENDER TO THE BORROWER AND THIS SUBSIDY IS ULTIMATELY BORNE BY THOSE WHO RECEIVE THE RETIREMENT BENEFITS FROM THE PENSION PLAN. SECONDLY, FUNDS CHANNELED INTO A FAVORED SECTOR, SUCH AS THE HOME MORTGAGE MARKET, CAN ONLY BE PROVIDED AT THE EXPENSE OF SOME OTHER INVESTMENT SECTOR WHICH WOULD BE DEPRIVED OF FINANCING, THESE COULD INCLUDE INVESTMENTS SUCH AS THE FUNDS NEEDED FOR NEW PLANT EXPANSION, FOR TECHNOLOGICAL IMPROVEMENTS IN PRODUCTION METHODS, OR FOR FINANCING SMALL AND GROWING BUSINESS FIRMS. IT MUST BE RECOGNIZED THAT THESE FORMS OF FINANCING ALSO SERVE HIGHLY IMPORTANT ECONOMIC AND SOCIAL NEEDS OF OUR NATION AND GREAT CARE SHOULD BE TAKEN IN RECHANNELING FUNDS AWAY FROM SUCH NEEDS.

THIS SITUATION IS EVEN MORE STRIKING IF THE DIRECTED INVESTMENTS INTO CERTAIN AREAS ARE TO BE LOANED AT BELOW MARKET INTEREST RATES, AS HAS BEEN SUGGESTED IN SOME RECENT PROPOSALS. THE BASIC QUESTION IS THIS: SHOULD BENEFICIARIES OF PENSION PLANS, A GROUP WHICH INCLUDES LOW-INCOME INDIVIDUALS, BE CALLED UPON TO PROVIDE SUBSIDIES TO THOSE SEEKING TO BORROW MONEY IN THE HOME MORTGAGE MARKET, INCLUDING INDIVIDUALS WITH HIGHER INCOMES? THIS SOCIETAL QUESTION WHICH MIGHT FAIRLY BE VIEWED AS AN UPWARD REDISTRIBUTION OF CAPITAL IN MANY CASES, MUST BE WEIGHED CAREFULLY BEFORE A DECISION IS MADE TO INTERFERE WITH MARKET RELATIONSHIPS.

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AS A CONCLUDING COMMENT, LET ME POINT OUT THAT OUR SOCIAL PRIORITIES TEND TO CHANGE OVER TIME. ALL OF US IN THIS ROOM CAN RECALL WHEN THOSE HEADING THE EVER-CHANGING LIST WERE ENERGY, INNER-CITY DEVELOPMENT AND LOCAL GOVERNMENT FINANCING. OBVIOUSLY, EACH OF THESE PRIORITIES IS WORTHY OF OUR CONTINUING CONCERN AND BEST REMEDIAL EFFORTS. WE SUBMIT, HOWEVER, THAT RETIREMENT INCOME IS A PROBLEM OF EQUAL SIGNIFICANCE, ESPECIALLY IN VIEW OF THE STATE OF SOCIAL SECURITY. PROPOSED LEGISLATION WHICH WOULD IN ANY WAY COMPROMISE THE LEVEL AND SECURITY OF RETIREMENT INCOME SHOULD BE, IN OUR OPINION, VERY CAREFULLY CONSIDERED AND BALANCED AGAINST COMPETING PRIORITIES BEFORE IMPLEMENTATION.

Senator CHAFEE. Mr. O'Brien isn't here I understand. Mr. Granof, are you pinch-hitting for him?

Mr. GRANOF. Yes, sir. I'm the designated pinch-hitter. As you may know, Dick O'Brien, the assistant treasurer of General Motors is scheduled to testify today before the Senate Labor Committee.

Senator CHAFEE. The increase of payment?

Mr. GRANOF. Yes, sir. The increase in premium. And he had anticipated—in fact, I had anticipated—he would be able to do both.

Senator CHAFEE. Well, he sent a very able substitute, I am sure, so why don't you proceed?

STATEMENT OF EUGENE B. GRANOF, ON BEHALF OF THE ERISA INDUSTRY COMMITTEE

Mr. GRANOF. Thank you. I certainly appreciate the opportunity to appear today on behalf of the ERISA Industry Regulations Committee, which goes by the acronym of ERIC. ERIC's 112 members include half of the Nation's 50 largest industrial companies and represent a cross-section of the Nation's largest retailers, utilities, banks and insurers.

Senator CHAFEE. Who are you with, Mr. Granof?

Mr. GRANOF. I'm with the law firm of Vedder, Price, Kaufman, Kamnholz and Day, and we are counsel for ERIC.

Participants in pension plans sponsored by ERIC members total approximately 8.5 million people or about 20 percent of all participants in private pension plans.

Briefly summarizing our statement, which we have submitted, I suppose the key to our position is that pension plans should seek to maximize returns and minimize risks. We have a specific concern about proposals, recent proposals, to encourage the investment of pension funds in a variety of socially useful projects, including residential mortgages. And our position and ERIC members believe that such investments are proper only if they otherwise meet the

ERISA prudence standards. The investment of pension fund assets is an inappropriate vehicle for pursuing otherwise desirable social objectives, including resolving the Nation's housing problems. Otherwise, sound investment policy should not be compromised and deluded by the introduction of secondary objectives no matter how socially desirable they may be.

We have a specific concern—or at least ERIC members do—about the use of pension funds to stimulate the direct purchase of residential units by plan participants because such purchases have to consider the economic realities of bankruptcy, relocations and plant shut-downs, all of which can affect the liability of those kinds of investments. Whereas we do have a significant concern about such direct investments in employee mortgages, indirect investment and low- and middle-income housing through participation and mortgage backed securities may provide for attractive investments which meet the ERISA standards of prudence.

In fact, in addition, many pension plans' funds have found commerical and industrial real estate to be satisfactory plan investments both directly and through investment pools. If residential real estate or mortgages provide appropriate returns and prudent investments, fiduciaries will make those kind of investments.

In sum, we recognize that attractive or appropriate investments for any specific plan depends upon many variables, including the plans total asset mix and return on other investments. Our concern, however, is with altering the traditional prudence standards.

Thank you very much.

[The prepared statement of Richard F. O'Brien follows:]

STATEMENT OF RICHARD F. O'BRIEN

ON BEHALF OF

THE ERISA INDUSTRY COMMITTEE (ERIC)

REGARDING

PENSION FUND INVESTMENTS IN RESIDENTIAL HOUSING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS & INVESTMENT POLICY

SENATE FINANCE COMMITTEE

May 19, 1982

I am Richard F. O'Brien, Assistant Treasurer, General Motors Corporation in New York. I appear today on behalf of The ERISA Industry Committee ("ERIC"). ERIC's 112 members include half of the nation's fifty largest industrial companies and represent a cross-section of the nation's largest retailers, utilities, banks and insurers. Participants in pension plans sponsored by ERIC members total approximately 8.5 million people which represents about twenty percent of all participants in private pension plans.

I welcome the opportunity to present ERIC's views in connection with the Subcommittee's examination of the investment of pension fund assets in residential mortgages. ERIC believes that the primary objective of pension plan investment is to insure that workers will have secure income after retirement.

Recently, there have been proposals to encourage the investment of pension funds in a variety of "socially useful" projects, including residential mortgages. Generally, ERIC believes that such investments are proper only if they otherwise meet the ERISA prudence standards. The investment of pension fund assets is an inappropriate vehicle for pursuing otherwise desirable social objectives, including resolving the nation's housing problems. Otherwise sound investment policies should not be compromised or diluted by the introduction of secondary objectives, no matter how socially desirable they may be.

ERISA clearly directs fiduciaries to invest plan assets prudently, solely in the interest of participants and beneficiaries, and for the exclusive purpose of providing current and future benefits in accordance with plan provisions. In so doing, the protection of retirement income must continue to be the sole, overriding concern of pension plan fiduciaries charged with investing pension assets. The interests of retirees should not be subjected to any risk that pension capital may be diverted to any investment which fails to meet ERISA standards. To the extent that pension capital is not maximizing fund returns, the plan sponsor in non-contributory plans, and both the sponsor and participants in contributory plans, will be required to make up the shortfall--which could put a marked strain on the financial well-being of the employer.

Any proposal to use pension funds to stimulate the direct purchase of residential units by plan participants must consider the economic realities of bankruptcy, relocation and plant shut-downs. If a plan sponsor were to fail or relocate, the payment of residential mortgages in which pension funds were invested could be jeopardized if a large number of plan participants who held such mortgages were out of work. Such events would impact not only the current income of participants but their pension interest as well.

Whereas ERIC has significant concerns about direct investment in employee mortgages, indirect investments in low and middle income housing through participation in mortgage-backed securities may provide for attractive investments which meet the ERISA standards of prudence. Some pension plans already invest a portion of their portfolios in mortgage-backed securities such as Government National Mortgage Association instruments ("Ginny Maes"). Whether such investments are attractive or appropriate for any specific plan depends upon many variables including that plan's total asset mix and the return on other investments.

Many pension funds have found commercial and industrial real estate to be satisfactory plan investments, both directly and through investment pools. There is no reason to mandate any specific type of real estate investment for pension plans, whether residential or otherwise. If residential real estate or mortgages provide appropriate returns and are prudent investments, fiduciaries will make such investments.

In conclusion, we believe that there is no higher goal for pension funds than insuring that employee income in retirement is protected through prudent investment of these funds. On this basis, we believe that the assets in trust funds of employer-sponsored pension plans must continue--as set forth in section 404 of ERISA--to be invested "solely in the interest of participants and beneficiaries...for the exclusive purpose of providing benefits to participants and their beneficiaries."

Senator CHAFEE. Thank you. Now I am a little confused. I thought that—you say that pension plans already invest in mortgage backed securities such as Ginnie Mae. It was my understanding that the passage of these recent exemptions now will permit them to go into Fannie Maes and Ginnie Maes and so forth. What's right? Am I mixed up or could you straighten me out? Mr. Moore, do you have any thoughts on that?

Mr. MOORE. We currently hold mortgage backed securities in pooled accounts for pension funds. This exemption, as I understand it from what I have heard this morning, would extend that exemption to individual mortgages.

Senator CHAFEE. I see. Instead of investing in the mortgage backed securities, you would be investing in the individual mortgages themselves in some kind of a pool form.

Mr. MOORE. That's my understanding, yes, sir, Mr. Chairman.

Senator CHAFEE. Now what do we say, Mr. Granof and Mr. Moore, to Mr. Georgine's point that you invest in some kind of a stock, prudently invest in it, and it takes a dive in the stockmarket so you are not very well off. But that's not considered imprudent. But investment in a mortgage is certainly a stable, high yielding investment and that there is this variation between a couple of points, as he indicated, that shouldn't be the completely controlling factor. In other words, if you go for a lower yielding mortgage that deals with their members, you may well be helping the pension fund itself by having more members contribute to it. And you have some indication of what kind of people they are through their association with the fund of which they are a potential beneficiary. What do you say to that?

Mr. MOORE. I'd comment that it gets back to the initial asset allocation of the plan. And it's difficult to compare the risk reward of common stock with what has been in the past considered a fixed income investment. And beyond that, when you look at equities you should be paid in the form of upside potential for taking the additional risk. And I think that is what has been reflected partially in the past in the level of interest rates. And it is difficult to compare the returns on equities as opposed to what is available in the fixed income area.

Mr. GRANOF. Senator?

Senator CHAFEE. Yes; I see Mr. O'Brien is here.

Mr. GRANOF. Mr. O'Brien. And I think he is prepared to respond to that question.

Senator CHAFEE. We understand you were well engaged. And I know that hearing was going on. And Mr. Granof ably represented you.

Mr. O'BRIEN. Fine, sir. Senator, I think basically with respect to the residential real estate mortgages that while you mentioned a couple of points, a couple of percentage points to a large plan or any plan could mean a significant—could have a significant impact on that plan's contribution to the pension fund. An example—a 2-percentage point of return on the General Motors' pension fund, which is $13½ billion, would equal $260 million, $270 million. So that over a 5-year period, for example, we are talking about well over a billion dollars. That give-up in return, ultimately, has to be reflected in increased contributions for the plan. Or correspondingly, any additional returns gets reflected as a lowering of the contributions to the plan.

Senator CHAFEE. We were never suggesting the whole thing. You were taking 2 percent of the whole fund. What Mr. Georgine was suggesting was for a modest amount to be set aside for the benefit of its members so that more members of his union would be employed and then there would be more contributed.

Mr. O'BRIEN. I think we can all find some socially desirable investments. In the auto industry, for example, in a capital constraint period, I am sure that General Motors would want to have a piece of that $13½ billion pension fund.

Senator CHAFEE. How about if we put it into auto loans? Would that be more tempting? [Laughter.]

Mr. O'BRIEN. I would think that if the pension funds were required to be invested in auto loans that we would object to that. I would think that we wouldn't refuse any help that we could get from other means, but certainly through the pension funds, I think that that would only be a delusion of a return on the funds. And ultimately would be to the detriment of the beneficiaries of the plan.

Senator CHAFEE. You weren't here, but the argument is that more auto loans, thus, more General Motors' employees, thus, more contributors to the fund, thus, the fund is better off.

Mr. O'BRIEN. Perhaps. The corresponding other arguments of that with respect to housing, for example, would be that the pension funds, which are really used to pay benefits in the event that an employer goes out of business—that's what they are there for. If an employer goes out of business, it's to back up that pension promise. Most companies have pension contributions that exceed the payments to the retirees. So we are building up really a big fund in which the stream of money going into the fund and in the interest earned on the fund benefits is greater than the stream coming out. So the fund is building up in the event the employer has some unforeseen financial hardship and can't make good on his pension promise.

If those funds are then invested back in an employee's home, it would seem that would doubly jeopardize the employee from the standpoint of reducing the funds ability to pay the promised benefits to the extent that the employer, through some unforeseen financial hardship, is unable to continue in operation.

Senator CHAFEE. Well, let's hear from Mr. Hobgood. I apologize, Mr. Hobgood. We have excluded you to some degree, but that just means we savor all the more what we are going to hear from you.

Senator BENTSEN. I couldn't agree with you more since he is a Texan and you ought to save that kind of wisdom for the last.

Senator CHAFEE. Well, first I would like to welcome our distinguished member from Texas, Senator Bentsen. And, Senator, if you have a statement—I know that you are very interested in 1910, and we had fine testimony from Mr. Glickman on your bill. And he was very receptive to your measure, and indicated that he had a couple of minor problems with it that he looked forward to discussing with you and your staff.

Senator BENTSEN. Thank you very much, Mr. Chairman. I appreciate that. I have no prepared statement at this time, but I do have a statement on the next subject that will be before us.

Senator CHAFEE. Fine. Why don't we go ahead then with your fellow Texan, Mr. Hobgood.

STATEMENT OF GORDON HOBGOOD, JR., EXECUTIVE VICE PRESIDENT, TRUST, FIRST NATIONAL BANK IN DALLAS, DALLAS, TEX., ON BEHALF OF AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. HOBGOOD. Thank you, Mr. Chairman. I'm Gordon Hobgood, executive vice president, trust, First National Bank in Dallas. I currently serve as chairman of the Asset Management Committee of the Trust Division of the American Bankers Association and that is the capacity in which I appear before the committee today.

We are pleased to discuss with you and the other members of the subcommittee mortgage investment by pension funds. We congratulate you on the hearings and your looking into the impediments which serve to discourage investments in mortgages.

The prohibited transactions provisions are, in our opinion, the overriding problem that we have with ERISA in administering plans. In our view, it is these prohibitions contained in section 406 of ERISA which serve as a major deterrent to investment of employee benefit plans in assets other than stocks and bonds and other publicly traded securities through brokers. The prohibited transaction provisions do not apply to securities purchases or sales where there is a blind purchase through a broker. But mortgages, mortgage related investments and other direct or private placements have become a nightmare of complexity because of these sections and the breadth of parties in interest particularly the number and variety of service providers who may be involved in these transactions.

While we know that there have been certain exemptions given this week by the Department of Labor, and we understand that the staff has begun to work on additional exemptions from the party in interest prohibited transactions for certain qualified asset managers, and our association applauds these efforts, we must recognize that administrations and individuals change. Therefore, short of the repeal of section 406(a), the ABA urges Congress to codify the exemption.

In addition to the difficulties caused by prohibited transactions, the investment considerations and operational factors also influence a portfolio manager's decision to invest or not invest in residential mortgages. Liquidity is a problem. I think as you have talked, we have talked about Ginnie Maes and other passthrough certificates. And, again, these are not as readily marketable as other certificates.

On reflection, Mr. Chairman, it appears from conversations with other pension investment managers around the country that a need is being recognized for a new instrument in the area of investment of mortgages for institutional funds. The instrument should have a high degree of liquidity, be readily ascertainable in value, offer certainty for the timing in the amount of payment, and otherwise be operationally simple. We trust that the private sector, with the encouragement of government, has the ingenuity to develop this type of instrument.

In summary, Mr. Chairman, the ABA would strongly oppose any effort to dilute the prudence standard or mandate the allocation in any type of socially desirable investment whether it be residential mortgages or job creative. We agree with the Congress directive in ERISA that the provisions of retirement benefits for our Nation's retired workers is in and of itself a social goal of the highest order. We would stand firmly against any attempt to weaken the fundamental standards of ERISA to further the social ends of the day.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you, Mr. Hobgood, for a fine statement.

[The prepared statement follows:]

STATEMENT

OF THE

AMERICAN BANKERS ASSOCIATION

Mr. Chairman, I am W. Gordon Hobgood, Jr., Executive Vice President, Trust, First National Bank in Dallas. Presently I serve as Chairman of the Asset Management Committee of the Trust Division of the American Bankers Association and I appear in that capacity. ABA is a national trade association whose members consist of more than 13,000 banks, more than 90 percent of the full service banks in the United States. More than 4,000 of these institutions are authorized to serve as fiduciary and many of these presently serve employee benefit plans in one capacity or another.

We are pleased to discuss with you and the members of the subcommittee, mortgage investment by pension funds. We congratulate you for holding this hearing to address the impediments which serve to discourage mortgage investment.

ABA has testified on numerous occasions before this and other Congressional committees on the difficulties ERISA's prohibited transactions cause plan fiduciaries and investment managers. These provisions are the overriding problem we have with ERISA in administering plans. In our view it is these prohibitions, contained in Section 406 of ERISA, which serve as a major deterrent to investment of employee benefit plans in assets other than stocks, bonds and other publicly traded securities through brokers.

The provisons enumerate a broad list of transactions into which a fiduciary may not cause a plan to enter.

Subsection (a) of Section 406 lists the activities into which a fiduciary may not cause a plan to enter with a "party in interest", while Subsection (b) prohibits transactions which are essentially self-dealing in nature. A "party in interest" is defined to include an almost limitless class: an employer, or 50 percent owner of an employer, whose employees are covered by the plan, any counsel or fiduciary of the plan, or a relative of any of these. The term also includes employee organizations whose members are covered by the plan and any employee, officer, director, 10 percent shareholder or partner or joint venturer of an employer, service provider to the plan or employee organization.

The types of transactions prohibited include sales or exchanges of property, lending of money, furnishing goods or services and the transfer to or use by a party in interest of any of the plan's assets.

When one considers that many large plans have several banks, investment advisors and insurance companies, all managing portions of the investments, not to mention all the other entities which may provide services to the plan, total avoidance of prohibited transactions becomes virtually impossible in the ordinary course of business.

The number and variety of possible transactions that are prohibited are enormous and the vast majority would be innocently entered into in the plan participants' best interests. It is unreasonably burdensome for even the most diligent trustee to keep track of or even know the ever changing list of parties in interest and to review all these relationships with respect to each and every plan transaction. This is particularly true where large U.S. companies and large plans are involved. It is exceedingly difficult if not impossible for a bank trustee to even know of all the various employers in a Taft-Hartley trust, particulary when there would be no other reason to know them except for prospective prohibited transactions. Implementation of the needed procedures is expensive and time consuming, and serves no productive purpose other than avoidance of a violation of these provisions.

The prohibited transaction provisions do not apply to security purchases or sales where there is a blind purchase through a broker. But mortgages, mortgage-related investments and other direct or private placements have become a nightmare of complexity because of Section 406(a), and the breadth of parties in interest and the number and variety of service providers who may be involved in these transactions.

Because our experiences with the exemptive procedures of the Department of Labor have been unsatisfactory to date, ABA has repeatedly urged repeal of the prohibited transactions provision, at least that portion relating to transactions with parties in interest. We believe the standards of undivided loyalty, exclusive purpose and prudence contained in other provisions in ERISA make Section

406(a) redundant and unnecessarily burdensome.

At the same time Mr. Chairman, we recognize that a new emphasis exists within the Department of Labor and that efforts to eliminate some of the burdens have begun. We understand that the mortgage exemption proposed last December will be issued soon and that a class exemption for mortgage pool investment trusts will be issued. Also the Secretary of Labor announced and we understand the staff has begun work on an additional exemption from the party in interest prohibited transactions for certain qualified professional asset managers and that there may be some consideration given to narrowing the needlessly broad scope of "party in interest" to eliminate those parties which are more remote to particular plan transactions. Our Association applauds the direction of these efforts. At the same time we must recognize that administrations and individuals change. Therefore, short of repeal of Section 406(a), ABA urges that Congress codify these exemptions.

In addition to the difficulties caused by the prohibited transactions provisions investment considerations and operational factors influence a portfolio manager's decision to invest or not to invest in residential mortgages. Liquidity is one important consideration. Mortgages are simply not readily saleable nor are GNMA or other pass through certificates as readily marketable as competing instruments. Committing funds for as long as 30 years in today's volatile interest rate and uncertain investment climate may be called into question. Professional investors are understandably reluctant to commit themselves to even long term governments and high grade corporate issues with extended maturities.

Mortgages are costly to acquire because of the documentation relating to title, security, recording and the like which must be checked even when purchasing "packages" of mortgages. After acquisition, mortgages present accounting and operational problems unique from most competing investments. GNMA and other mortgage-backed certificates help to alleviate some of these problems but in the process they produce their own difficulties. Payments are notoriously late, often more than two weeks after payable date and, because of principal prepayments, uncertain in amount. Because of these unique characteristics, even though mortgage rates are today very high, the costs of handling mortgage investments are also high and thus the net yield is often less than competing investments.

It must also be pointed out that mortgages are inappropriate investments for defined contribution plans. These plans, because of their need for frequent valuation require liquid highly marketable investments to permit rapid and precise valuation of accounts.

On reflection, Mr. Chairman, it appears from conversations with trust investment managers around the country that a need is being recognized. A new instrument must be developed which will attract institutional funds into residential mortgages without all the difficulties which must be encountered today. That instrument should have a high degree of liquidity, be of readily ascertainable value, offer certainty of the timing and amount of payment, and otherwise be operationally simple. We trust that the private sector, with the encouragement of government, has the ingenuity to develop this instrument.

Mr. Chairman, ABA is gravely concerned about proposals for mandating or allocating pension investments for social purposes. The ABA supports your effort to focus on impediments which serve to stifle the free flow of funds into important favored segments of the economy. We firmly believe that the fundamental standards contained in ERISA are sound. A fiduciary must carry out his responsibilities as would the "prudent man", under similar circumstances, "solely in the interests of the participants and beneficiaries". Further, the fiduciary must be ever mindful that the "exclusive purpose" of employee benefit plans, in the words of ERISA, is to provide "benefits to participants and their beneficiaries". The trustee, in choosing particular investments, must take into account all the present facts and circumstances and the prospects for the future. Additionally, ERISA requires that the investments be diversified so that the risk of loss is minimized. Thus, in picking the investments which make up a particular portfolio there is no built-in bias toward any particular type of security. The portfolio consists of a mix of securities chosen in such a way as to balance the level of risk of the portfolio in relation to the potential for income and capital appreciation. ERISA's prudent man rule allows for investment in all types of assets.

But ABA would most strongly oppose any effort to dilute the prudence standard or to mandate the allocation in any type of socially desirable investment whether it be residential mortgages or job creating. We agree with Congress' decision in ERISA that the provision of retirement benefits for our nation's retired workers is, in an of itself, a social goal of the highest order. We would stand firmly against any attempt to weaken the fundamental standards in ERISA to further social ends of the day.

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MBA
News Release

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FOR IMMEDIATE RELEASE May 19, 1982

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MBA APPLAUDS DOL EASING RESTRICTIONS ON PENSION FUND INVESTMENT IN REAL ESTATE

WASHINGTON, D.C. -- The Mortgage Bankers Association of America (MBA) today hailed the action taken Friday by the Department of Labor to make it easier for the nation's pension funds to invest in residential mortgages as "encouraging news that the Reagan Administration has recognized that new sources of credit will have to be found-if homeownership is going to remain a real possibility for most Americans."

Dr. Mark J. Riedy, Executive Vice President of MBA, said the steps taken were necessary "to ensure the continued availability of mortgage credit," but added that as much as he welcomed the recent DOL actions, there remained unnecessary restrictions on pension fund investment in real estate.

"The decline in mortgage lending activity by the thrift industry, when coupled with the decline in personal savings deposited with the thrifts, makes it absolutely critical that others with large amounts of funds to invest in residential mortgages have every opportunity to do so without any restrictions imposed on them except by their own common sense." Pension funds currently have about $750 billion in assets and are among the fastest growing vehicles for savings in the nation.

The first of the three separate actions taken Friday by the Department of Labor would allow pension funds to engage in a broad range of transactions involving the financing of residential mortgages. Pension funds can now directly acquire, sell, or exchange mortgages, and can purchase or sell "participations" in real estate transactions. The types of mortgage loans covered by the regulatory change are defined as those eligible for purchase by the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), or the Federal Home Loan Mortgage Corporation (FHLMC). The change permits the purchase of various types of adjustable rate mortgages, second mortgages and "buy-downs," where the permanent interest rate is reduced for a period of time by an up-front lump sum payment equivalent to the difference between the permanent rate and an agreed-upon lower rate for the time involved.

While emphasizing that forcing investments to conform to the requirements of these secondary mortgage market agencies provides guidance to pension funds and ensures prudent investment practices, Riedy called the limitation "unnecessarily restrictive." Ordinarily, FHLMC, FNMA and GNMA have limits on the amount of the individual loan that qualifies for inclusion in mortgage pools they will purchase. In most cases, these limits match the current FHA or VA loan limits.

"There is no reason why pension funds should be able to invest only in mortgages that FNMA or FHLMC will purchase," Riedy said. "In fact, the higher balance loans are as secure, if not more secure, than those with lower balances. The action has the effect of targeting the program toward the lower and middle income homebuyer, and it appears to be motivated by a social concern, not a business concern. There is no good business reason for excluding mortgages from more expensive homes from the mortgage pools eligible for purchase by pension funds."

Riedy pointed out that ERISA rules require prudent investment based on sound underwriting principles and that a pension fund is not likely to take a flyer on a risky investment.

"Unfortunately, by defining for the pension fund the types of mortgages that can be purchased, it becomes impossible to 'custom tailor' a program for a particular fund. We would prefer that the opportunity to purchase any type of mortgage was left up to the pension fund. We need that flexibility," Riedy added.

Riedy said that the change that permits any financial institution or business organization that normally advises on real estate investment to serve as an investment counselor to a pension fund is "certainly appropriate," but quickly added that the rule requiring an independent fiduciary to participate in a mortgage investment decision is still in force.

"This is a situation in which an outside third party has to agree to an investment decision two other equally qualified institutions have already accepted. It's burdensome and unnecessary. Any third party involvement should be on a voluntary basis, not mandated in all cases," he said.

In testimony before the Senate Committee on Finance Wednesday, MBA representative Douglas Johnson, Vice President of Chase Home Mortgage Company, of Montvale, N.J., made similiar observations concerning the changes affecting pension plan investment in residential mortgages.

Calling the changes "a giant step on the way toward freeing up pension funds for investment in mortgages," Johnson noted that the new rules still "saddle mortgage investment with the mandatory cost of hiring a real estate investment advisor, even where (the pension funds) are themselves knowledgeable."

The second major proposed action taken by the Department of Labor Friday permits pension funds to agree to purchase pools of first or second mortgages for delivery at a specified time in the future and at an established rate of interest. Riedy said that this would encourage lenders to originate loans, because they would be certain of selling those loans to permanent investors.

"Obtaining a forward commitment permits lenders to make a commitment to a specific rate," said Riedy. "This gives consumers a sense of security, because they know what their interest rate will be at time of closing," he said.

The third, and final, action taken Friday makes clear that the assets of an employee benefit plan include the mortgage pool certificates that are guaranteed by GNMA, FNMA, or FHLMC, but do not include the mortgages underlying such governmental mortgage pools.

Riedy said he was "gratified" that the actions were initiated at the direction of President Reagan, in response to recommendations of the President's Commission on Housing.

"While any one of us could argue with many aspects of their report, it is still an excellent report and one that will set the direction of the federal government's involvement in housing for years to come," he said.

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MBA, headquartered in Washington, D.C., is the national real estate finance trade association representing more than 1900 member mortgage companies, commercial banks, life insurance companies, savings and loan associations, and others in the mortgage lending field.

Senator CHAFEE. Now as I understand what you are saying—while the regulations that have been issued dealing with the amendments to the prohibited transactions, you are somewhat nervous or alarmed that these could be changed. And, thus, you ask that they be codified. Am I correct in that?

Mr. HOBGOOD. Yes, sir.

Senator CHAFEE. In other words, we pass a law to that effect.

Mr. HOBGOOD. Yes, sir.

Senator CHAFEE. Now you haven't had a chance to study what the Department of Labor has done to date. That goes far enough or are you not sure?

Mr. HOBGOOD. We have not had an opportunity to do that. Again, I think even with that, we would hope to have further clarification. I think also as you mentioned in your earlier conversation on your visit with other managers, there are problems other than just prohibited transactions as we look at this. We have talked about yield and what leads an investor into this type of investment. There are problems that relate to that, I think, that could be addressed by taking away the prohibited transactions in party in interest situations—situations that make it very costly for an investor. Again, not just talking about the yield on the mortgage per se but the servicing cost that goes along with that, which expenses in turn go to the net yield which would be less than what we have talked about today. That is one of the reasons, in my opinion, professional investors have stayed away from home mortgages in the manner in which they are packaged today.

Senator CHAFEE. Yes; but you pointed out that if we removed these—changed these prohibited transactions, then you believe that the operations to the market place will result in ingenuity of the banking community to come up with something that can be packaged attractively for you.

Mr. HOBGOOD. Yes, sir. If these provisions or prohibitions are removed, I think there are enough imaginative young people in the world today who will find a way to package this type of instrument in a way that will be marketable and provide the needs of the investor.

Senator CHAFEE. How does it work? Now when you buy Ginnie Maes or Fannie Maes under the regulations that have existed, did you have to investigate every mortgage in the pool?

Mr. HOBGOOD. I think you would probably find a variety of answers from different banks. In our bank, we did not in buying Ginnie Mae passthroughs go back and review all the mortgages behind the pool. We felt there were certain exemptions that would protect us in buying that type of thing third handed through a broker. The principal problems with those have been the valuation problem in the market place, the ability of the manager to receive his funds on a specified date in order that he could put it back for the individual plan, and knowing how those funds would come in. The paydown on the mortgages initially, when they were bought, was thought to be, let's say in the 7 to 10 year period although they were longer pieces of paper. As interest rates have gone higher, there have been fewer prepayments. And, therefore, the instrument has become as it really was initially directed, a long-term investment 20 years and plus. But you didn't know when it was coming. And then the market place, in effect, changed the valuation of the instrument.

In other words, where initially it was valued as an intermediate term investment, it then moved to the long end. So, therefore, if you tried to sell it, you incurred a much more substantial discount from the unpaid principal than originally was anticipated. Therefore, many people stayed away from this. It became less liquid in the marketplace. And, therefore, I think, many investors have said to themselves, if I am going to have requirements—many times you don't have but sometimes you are required—and then I say to myself if I can't sell it readily and get my money back, and if I don't have a greater anticipation of how it is going to be priced, then I am going to stay away from that investment. In effect, it becomes riskier to me than it would be to go to a government bond or maybe a corporate bond. I think this has been a problem. In our situation we have made some individual investments in mortgages. Again, in situations where we probably could say there would be no need for liquidity. But we have not been very active in mortgages and individual home residences for that reason. It is very difficult to put together. And very difficult to market if you need anything. But I do believe an instrument can be created with certain impediments taken out of the marketplace over a period of time that would make this acceptable, and something that institutional traders across the country would be willing to use.

Senator CHAFEE. Thank you. Senator Bentsen.

Senator BENTSEN. Yes, I would like to comment on that because I was very much in a part of the revision of the prudent man rule. The prudent man rule previously put a serious handicap on the individual asset that you invested in. What I was striving for was to see that you had diversification. That was the sensible way to approach it. I tried to put in some of the things that we had had in the insurance industry that allowed that type of thing. I couldn't agree with you more about trying to revise the investment policies of pension funds to accomplish social objectives for which that money was put in there for. That money was placed there to provide the pensioner with certainty, security, and assurance that that money is going to be waiting for him. Therefore, that trustee has the obligation to balance with safety and try to do what is best for the pensioner. So, I am in accord with you. I don't want to see us violate those standards. And I, too, believe that the prudent man rule is fulfilling its purpose.

Mr. HOBGOOD. Yes, sir.

Senator CHAFEE. Mr. Moore, how would you handle it in your institution as regards to prohibitive transaction problems in Fannie Mae?

Mr. MOORE. The same as mentioned earlier. We didn't review individually each mortgage made under the pools we are participating in.

Senator CHAFEE. OK, fine. Thank you very much, gentlemen. We appreciate you coming.

Now the next panel is Rev. Lawrence Washburn, Mr. Landes, Mr. Gordon Smith, Mr. Harold Clarke, Mr. Richard Kelly, and Mr. Gary Nash. If you will each come forward.

All right, gentlemen, just take any seat and we will adjust the name tag cards to go with where you are seated.

We welcome you. Senator Bentsen, you have a statement.

Senator BENTSEN. Yes; thank you very much, Mr. Chairman. And I am very appreciative of your scheduling this hearing on S. 1910, which my colleague, Senator Dole, and I have introduced. This bill has several provisions added that I have introduced in other sessions of the Congress. And over these earlier years, they have gained considerable cosponsorship. At one time, I know we had the support of 49 of our colleagues. An identical bill, H.R. 5067, has been introduced in the House by Congressmen Barber Conable and Jim Wright. The Church Alliance for Clarification of ERISA, S. 1910, is strongly embraced by virtually every major church denomination in this country, whether it is Catholic, Jewish, or Protestant.

The Church Alliance is an organization formed several years ago because of the concern over the impact of ERISA on the pension plans of ministers and lay employees. It consists of church pension program officers acting on behalf of 27 church denominations that I will list at the end of this statement.

I think it is urgent that this be enacted. On May 17, 1982, the Internal Revenue Service promulgated Revenue Ruling 82-102. This ruling says that only insurance companies may issue annuities described in section 403(b) of the Internal Revenue Code. As a result, this revokes long standing rulings that have been relied on by church pension boards so that they can be issuers of section 403(b) annuities.

Most of the retirement benefits issued by church pension boards are derived from that section. You have a grandfather clause in there to try to protect people who are supposedly already involved. But, that excludes those in the future that might want to retire and utilize the pension plan of church pension boards. Obviously, I think it is totally inequitable.

I think there are many other important reasons that it should become law. When it was enacted, we were not aware of the overly harsh limitations that were placed on the contributions that could be made to the retirement programs of that class. Typically, this consists of the poorly compensated persons, the ministers, and lay employees.

That was a massive bill, and I can remember the debates and the hearings that went on. It was a case of that facet of our population not being considered as they should have been. What this does is try to correct that kind of an oversight.

In 1958, we placed a restriction called the exclusion allowance on contributions that could be made. They are annuities without tax consequences to the employee. But that limitation is 20 percent of the employee's includible compensation multiplied by his years of service, plus the aggregate contributions made in prior years that were excluded from income. The exclusion allowance permits larger than usual catch-up contributions late in an employee's career to make up for years when contributions were low or they weren't made.

What we were trying to do, Mr. Chairman, is put a limitation on the very high salaried executives where they might try to pad a situation where they could retire and develop a windfall. But, we should have looked at the other end of the scale for the fellow that just wasn't properly compensated for years, where they were trying to bring about some equity for him as he retired. Obviously, we didn't address that. And we have asked to correct that in this situation.

The major thrust is to extend the election of section 415(c)(4) to ministers and lay employees. Because calculations regarding the elections are complicated and they are difficult to administer, we have put in a de minimis amount of some $10,000, subject to the exclusion allowance that can be added to a section 403(b) annuity without violating the 25-percent limitation.

It accomplishes other purposes designed to enhance the retirement incomes of ministers and lay employees. It is consistent with the approach the Congress has adopted lately of enlarging employee retirement opportunities.

And I don't know many ministers or lay people who working for the churches that are going to be able to take full credit for other approaches because they just don't have that fringe income to do it. So this is something to try to help them in that regard.

The bill also would make possible the accumulation of retirement benefits for ministers and lay employees who have such low compensation that the exclusion allowance prevents adequate contributions. Foreign missionaries are an example of that kind of a church employee.

S. 1910 would deem an includible compensation in an amount governed by the poverty level computed annually by the Office of Management and Budget. That is almost an indictment to have to refer to that in trying to make these allocations.

So I am advocating a new provision for S. 1910 that would provide a period time in which the church plans of all kinds—a period of time that they would have available to them to make such amendments as have to be made that are challenged by the Internal Revenue Service. And I know the problem that you have in the management of your church pension funds. Sometimes you don't have meetings except over a long period of time where you go without discussing the management of funds. This proposal would give you a period of time to try to get into compliance and take care of it.

I think it is very urgent that this be enacted. On May 17, 1982, the Internal Revenue Service promulgated Revenue Ruling 82-102. That ruling holds that only insurance companies may issue annuities as described in section 403(b) of the Internal Revenue Code. It revokes those published rulings long relied on by the church pension boards. And I think for that reason we have to move. Most of the retirement benefits of the church are derived from section 403(b) annuities issued by those pension boards, as I stated earlier. I would hope very much, Mr. Chairman, to correct this.

Senator CHAFEE. Well, Mr. Senator, any piece of legislation that has the support of every major church in the United States and every synagogue has attraction to me. And we thank you for that statement. And why don't we proceed?

Now, gentlemen, we are under some time constraints. I do have to leave at 12:30, but maybe we can go over to 12:35 to give every-body a chance. But why don't you each take about 3 minutes apiece.

Senator Bentsen is unable to stay so why don't we start with a distinguished Texan, Mr. Nash, general counsel of the annuity board of the Southern Baptist Convention.

Mr. NASH. Senator Chafee, we had planned——

Senator CHAFEE. Why don't you hold 1 minute, Mr. Nash.

Senator BENTSEN. No, that is fine. I was delighted to have him here and I was looking forward to his testimony.

Mr. NASH. In order to meet your time constraints, we had planned to start with Mr. Landes on the other end.

Senator CHAFEE. And you are the last?

Mr. NASH. Yes.

Senator BENTSEN. You want to tell me about it later? [Laughter.]

Mr. NASH. Thank you, sir.

Senator CHAFEE. Well, I just wanted to say that this is an issue that Senator Bentsen has been deeply interested in for many years. The reason that this legislation keeps you gentlemen here today is because of the deep interest that Senator Bentsen has in this proposal.

Mr. NASH. We all appreciate very much your holding the hearings, and Senator Bentsen's sponsorship and Senator Dole's sponsorship. And we would welcome you, sir, as a cosponsor also.

Senator CHAFEE. Well, I did want to include Senator Dole also having a deep interest.

Senator BENTSEN. Now that we have the chairman here as a cosponsor, this thing really ought to move. [Laughter.]

[The prepared statement of Senator Bentsen follows:]

STATEMENT OF HON. LLOYD BENTSEN, U.S. SENATOR

Mr. Chairman, I am grateful to your Subcommittee for scheduling a hearing on S. 1910, which my colleague, Senator Dole, and I have introduced. This is a bill that, with several worthwhile provisions added, I have introduced in other sessions of Congress. Over the years these earlier bills have gained the cosponsorship or support of 49 of our colleagues. An identical bill, H.R. 5067, has been introduced in the House by Congressmen Conable and Wright.

Through the Church Alliance for Clarification of ERISA, S. 1910 is strongly embraced by virtually every major church denomination in this country, Catholic, Jewish, and Protestant. The Church Alliance is an organization formed several years ago because of concern over the impact of the Employee Retirement Income Security Act of 1974, commonly referred to as ERISA, on the pension plans of ministers and lay employees. The Church Alliance consists of church pension program officers acting on behalf of 27 church denominations listed at the end of this statement.

I would like to thank the following persons for their participation in this hearing: Mr. Leo J. Landes, representing the United Synagogue of America; Mr. Gary S. Nash, Secretary of the Church Alliance and General Counsel of the Annuity Board of the Southern Baptist Convention; Mr. Wayne Reeves, Assistant General Counsel of the Annuity Board of the Southern Baptist Convention; Mr. Richard B. Kelly, Associate Director, Government Liaison, United States Catholic Conference; Reverend Lawrence A. Washburn, Minister of the Peace Dale Congregational Church, Peace Dale, Rhode Island; Mr. Gordon E. Smith, Treasurer, The Ministers and Missionaries Benefit Board of The American Baptist Churches; Mr. Harold A. Clarke, Manager, Pension and Benefits, Board of Pensions of the United Presbyterian Church in the U.S.A.; Mr. Walter F. Donnelly, Senior Vice President of The Church Pension Fund of the Episcopal Church; Mr. John E. McCracken, Resident Counsel of The Church Pension Fund of the Episcopal Church; Mr. Robert H. Rydland, Counsel to The Board of Pensions of the Lutheran Church in America; Mr. Thomas J. Moore, Counsel to The Division of Pensions, The American Lutheran Church; Mr. Leonard S. Hirsh, Counsel to The Board of Pensions of the United Presbyterian Church in the U.S.A.; and Mr. Eugene M. Stiles, Administrator, Retirement Plan of the General Conference of Seventh-day Adventists.

Mr. Chairman, it is urgent that S. 1910 be enacted. On May 17, 1982, the Internal Revenue Service promulgated Revenue Ruling 82-102. This ruling holds that only insurance companies may issue annuities described in Section 403(b) of the Internal Revenue Code. It revokes published rulings long relied upon by church pension boards that they can be the issuers of Section 403(b) annuities. Most of the retirement benefits of churches are derived from Section 403(b) annuities issued by church pension boards. While a grandfather clause in the ruling protects present church employees from adverse tax consequences, a new congregation, church, or church agency may not provide its employees with retirement benefits from church pension boards issuing Section 403(b) annuities. I do not believe that Congress wants to deny church employees access to the retirement benefits of their pension boards. A provision in S. 1910 makes it clear that churches and church pension boards have the right under our tax laws to be issuers of Section 403(b) annuities. Therefore, I ask my collegues to join me in supporting S. 1910.

For other important reasons, S. 1910 should become law. When ERISA was enacted, we were not aware that overly harsh limitations were placed on the contributions that can be made to the retirement programs of that class of typically poorly compensated persons, namely, ministers and lay employees. S. 1910 corrects this oversight and makes other changes that meet the needs of these programs.

In 1958, we placed a restriction, called the exclusion allowance, on contributions which can be made to Section 403(b) annuities without tax consequences to the employee. This limitation is 20 percent of the employee's includible compensation multiplied by his years of service and less the aggregate contributions made in prior years that were excluded from income. The exclusion allowance permits larger-than-usual, or catch-up, contributions late in an employee's career to make up for years when contributions were low or not made. ERISA superimposed a further limitation on contributions, which is the lesser of 25 percent of the employee's compensation or $25,000, adjusted by increases in the cost of living. The purpose of the 25-percent-limitation was to prevent very large contributions for highly compensated persons. However, this limitation offers no opportunity for ministers and most lay employees to make meaningful catch-up contributions toward retirement because these employees are seldom well compensated, even at the peaks of their careers. In 1974, we recognized the effect the 25-percent-limitation would have on the ill compensated and, in Section 415(c)(4) of the Code, gave employees of educational organizations, hospitals, and home health service agencies a series of elections to make out-of-the-ordinary contributions notwithstanding the 25-percent-limitation. Congress did not then consider the impact of this limitation on ministers and lay employees, who are in the same class of persons now benefiting from the elections.

A major thrust of S. 1910 is to extend the elections of Section 415(c)(4) to ministers and lay employees. Because calculations regarding the elections are complicated and difficult to administer, S. 1910 also provides a $10,000 de minimis amount, subject to the exclusion allowance, that can be added to a Section 403(b) annuity without violating the 25-percent-limitation.

S. 1910 accomplishes other purposes designed to enhance the retirement incomes of ministers and lay employees consistent with the approach Congress has lately adopted of enlarging employee retirement opportunities. Ministers and lay employees of many denominations change jobs on an average of every three to five years. In computing the exclusion allowance, years of service with the present employer only are counted. If years of service is low, then the exclusion allowance is also low. Because of many employment changes some church employees find themselves with perpetually low exclusion allowances, even though all their work has been for the same denomination. S. 1910 would include all years of service within the employee's denomination for purposes of the exclusion allowance.

This bill also would make possible the accumulation of retirement benefits for ministers and lay employees who have such low compensation that the exclusion allowance prevents adequate contributions. Foreign missionaries are examples of this kind of church employee. S. 1910 would deem an includible compensation in an amount governed by the poverty level computed annually by the Office of Management and Budget.

I am advocating a new provision for S. 1910. This would provide a period in which church plans of all kinds would have to make amendments if they are challenged by the Internal Revenue Service. Church plans need this assistance because their procedures for amendments are generally lengthy. In many instances, a plan amendment requires the approval of the highest governing body of the church. In some denominations this body meets but once every two years. This procedure would be similar to the correction period procedure for church plans in Section 414(e).

Mr. Chairman, the remarks of Senator Dole and myself in the Congressional Record describe S. 1910 more fully than I can here. With your permission, I would like to append these remarks to this statement.

CHURCH ALLIANCE FOR CLARIFICATION OF ERISA

An alliance of the chief executive officers of the pension programs of the following church denominations:

Union of American Hebrew Congregations
United Presbyterian Church in the U.S.A.
Church of God
Presbyterian Church in the United States
Reorganized Church of Jesus Christ of Latter Day Saints
Unitarian Universalist Association of Congregations in North America
African Methodist Episcopal Church
The Lutheran Church-Missouri Synod
Catholic Mutual Relief Society

United Methodist Church
United Synagogue of America
Southern Baptist Convention
Presbyterian Church in America
General Conference of Seventh-day Adventists
United Church of Christ
Church of God in North America
Episcopal Church
The Christian Church (Disciples of Christ)
The Wesleyan Church
Church of the Brethren
The American Lutheran Church
Christian Reformed Church in North America
Lutheran Church in America
Church of the Nazarene
American Baptist Churches
Mennonite Churches
A.M.E. Zion Church

Senator CHAFEE. All right, Mr. Landes, why don't you proceed?

STATEMENT OF LEO J. LANDES, ADMINISTRATOR, JOINT RETIREMENT BOARD, UNITED SYNAGOGUE OF AMERICA, NEW YORK, N.Y.

Mr. LANDES. Thank you very much.

I would just like to say that we wanted Gary Nash to bat cleanup, and that is why we have had him speak last.

I am Leo Landes, and I represent the joint retirement board of the United Synagogue of America. We are a small pension plan with 1,500 rabbis and lay employees, and representing about 800 synagogues. I come from a rabbinical family. My father was a rabbi in a small town in New England for over 55 years.

Senator CHAFEE. What was the town?

Mr. LANDES. The town was Revere, Mass. My two brothers serve as rabbis. I am very conscious of the problems and the benefits of the rabbinate and the synagogue. And I am here representing the United Synagogue, but today I am representing more that the United Synagogue. I am representing the Church Alliance for Clarification of ERISA, which involves all of the major Catholic, Protestant, Jewish churches and synagogues as well as religious organizations in the country.

We've discovered that we all have similar serious problems. And we have asked for legislation which can help every single one of our people.

I would like to give you an idea, of the organizations that are involved here by introducing the people that came. We have myself with the United Synagogue; Gary Nash with the Southern Baptist Convention; Wayne Reeves with the Southern Baptist Convention; Richard Kelly with the United States Catholic Conference; Rev. Lawrence Washburn with the United Church of Christ; Rev. Gordon Smith with the American Baptist Churches; Harold Clarke with the United Presbyterian Church; Walter Donnelly and John McCracken with the Episcopal Church; Robert Rydland with the Lutheran Church in America; Thomas Moore with the American Lutheran Church; Leonard Hirsh representing the Presbyterian Church in the United States; and Gene Stiles representing the General Conference of Seventh Day Adventists.

It's just a sampling of the people who came because they are interested. If we looked at the number of people in a sampling of the Protestant churches, we would find, as I did from a list that I looked at a week ago, that there were about or over 250,000 clergymen and lay employees in their pensions with over 160,000 churches. You notice if you look at the Jewish synagogues, or the Protestant churches, you have from the sampling of maybe less than two people, two employees, per organization. We are dealing with organizations that are small. They will generally have one or two professional employees. They may have a volunteer part-time clerical help, and that is it. They are not ready, they are not capable of doing long complicated figuring out of what they can put into a pension plan. I notice that even the Treasury Department in their oral testimony didn't go into an explanation of how to determine the exclusion allowance under section 403(b). If it is complicated to present here, it is certainly complicated for a small synagogue or church where you have so few people who know what is going on. What we are trying to do is simplify the plan to make sure that our people can get a more reasonable pension, especially to have money put in in later years when they are close to retirement.

As you know, clergymen and lay employees of synagogues and churches are not highly paid.

We are not concerned with people that are making $30,000, $40,000, $50,000 a year. We are talking about people generally who are making $15,000, $20,000, $25,000 a year maximum. And we are talking now about getting a right to put in a—I can't even say a decent amount, but getting in the last 4 or 5 years the privilege to have someone from the congregation put in money so that the person can build up—I won't even say a decent retirement—maybe a livable retirement.

We are asking for your help in accomplishing this.

Senator CHAFEE. Thank you, Mr. Landes. And I think as we proceed here, if you could include within your remarks a comment on the statements that were given by Mr. Glickman earlier when I believe all of you were here. Did you find the comments he made understandable?

Mr. LANDES. Well, I can refer to one thing that he said in particular that affected me. I didn't want to go into it, but I can. I think you will find it illuminating. I mentioned my father was a rabbi for 55 years in Massachusetts. He passed away about 6 years ago. My father was in the unique position of having earned as much when he retired as he did just prior to retirement. He retired about 20 years ago. He was making, at that time, the munificent sum of about $5,000 a year. When he retired, he collected about $3,000 a year from social security. And he had two synagogues, mind you. I am talking about the combination. One synagogue gave him a pension of $1,000 a year. The other one gave him a pension of $1,200 a year. So at retirement, he was earning $5,200 a year.

He had no help in the synagogue. There were no other employees. My mother served as the secretary, treasurer, jack-of-all-trades at the synagogue. If they needed something typed, they would get one of the members of the congregation to have his office type something up.

They simply could not be involved with figuring out anything. My father, in fact, had no pension, but the money was paid in by the synagogue at the time of retirement.

What we are looking for when we talk about a $10,000 de minimis, we are not talking about a $10,000 de minimis all the way through. We are talking the last 4 or 5 years before retirement. We can sometimes get a congregation, a church or a synagogue to have a member offer to donate to the synagogue, as long as they are not going to be involved with Government figures, maybe $7,000, maybe $8,000, maybe $10,000 a year so that their rabbi or preacher will have a little better retirement than he would have had before.

I tell you I used to succeed in doing this about five times a year. I did this until January 1976 when ERISA put a limitation of 25 percent of compensation. To see how this limits consider a compensation of $15,000. Twenty-five percent of this compensation is under

$4,000 a year. We are looking to raise that in those last few years before retirement for these low paid employees.

Senator CHAFEE. All right. Fine. Thank you very much.

[The prepared statement follows:]

96-536 O - 82 - 11

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Savings,
Pensions, and Investment Policy
2227 Dirksen Senate Office Building
Washington, D. C. 20510

STATEMENT OF LEO J. LANDES ON S. 1910

Mr. Chairman, I am Leo J. Landes, representing the Joint Retirement Board of the Rabbinical Assembly, Jewish Theological Seminary of America, and the United Synagogue of America. My father, of blessed memory, served one congregation in Revere, Massachusetts, as rabbi for over 55 years. My two brothers serve as rabbis, one in Pittsburgh, Pennsylvania, and the other in Elkins Park, Pennsylvania.

The United Synagogue is the conservative movement of American Judaism representing almost two million Americans. I am here to represent the Jewish faith throughout America. I also speak on behalf of every other church denomination of this country, each of which has a vital interest in S. 1910.

Nearly all of our governing organizations, synagogues, religious schools, theological seminaries, and other agencies use Section 403(b) annuities to fund retirement benefits for both our clergymen and lay employees. We choose annuities of this kind because they are completely portable and simple to administer. Most of our synagogues and agencies are small. Some are staffed full time only by a single clergyman. Clerical assistance will often be part time or voluntary. These small religious organizations simply are not able to handle complex administrative situations or do not have the experience or technical ability to manage other types of retirement programs such as the qualified plan.

Our problem is that for the past eight years contributions to our retirement annuities have in many cases been severely restricted by the 25-percent-of-compensation rule that was put into the Internal Revenue Code by the Employee Retirement Income Security Act of 1974 to limit contributions to defined contribution plans. As with most other faiths, the salaries of our rabbis and lay personnel are low. Thus, we see contributions to our pension programs restricted to a percentage of a salary that is very small. We feel that this restriction is unfair and one that is unnecessary since Congress has placed much higher limitations on contributions to defined benefit plans. I understand that the limitations on such a plan are high enough to produce retirement benefits equal to an employee's average salary for his high three years with an overall limit now of some $136,000 a year.

This certainly is not the case with our Section 403(b) annuities. The Internal Revenue Service has classified them as defined contribution plans, and we are subject to a rule that was put into the Internal Revenue Code to prevent enormous contributions by wealthy employees. I am sure that Congress did not intend to prevent our comparatively low-paid clergy and lay employees from retiring on adequate pensions. I am certain that Congress was not aware of our problems when it enacted the 25-percent rule.

The worst part about the 25-percent-rule is its inflexibility. Possibly if 25 percent of compensation were contributed to the annuities of our rabbis and lay employees from the beginning to the end of their careers, retirement benefits might be barely acceptable. They certainly would not be munificent.

But continuous contributions of 25-percent-of-compensation never happen. A clergyman at the beginning of his career is often employed by a congregation that does not have the funds to provide him with even a small annuity. The rabbi himself may make modest contributions through a salary reduction arrangement. However, for many years he will need every bit of his salary to feed and clothe his family and send his children to school. It is only toward the end of the rabbi's career that his salary may be enough to provide for adequate contributions. The rabbi finds that the 25-percent limitation prevents any sort of worthwhile catch-up contribution. What he needs is a rule that permits him for some time to make substantial contributions to make up for those years when no contributions or very small contributions were made.

S. 1910 has the inter-denominational support of congregations and organizations throughout the country. It provides the relief we need and, more importantly, relief that is equitable. It offers our rabbis and lay employees the same right as employees of certain other organizations to make the elections under Section 415(c)(4) of the Code which override the 25-percent limitation.

Next, S. 1910 would eliminate certain costs that are prohibitive for clergymen but necessary to fully utilize the present law. The calculations of the limitations under the exclusion allowance and the elections can be very complicated. As you know, the exclusion allowance is the amount of contributions to an annuity that is excluded from the income of an employee. In most cases, an accurate calculation requires the services of an attorney or other adviser who has had experience in making them. Most rabbis cannot afford this sort of professional service.

S. 1910 would permit us to contribute up to $10,000 to our annuities each year without violating the 25-percent limitation or having to make the elections. We will, however, be governed by the exclusion allowance, which permits reasonable catch-up contributions to our annuities but still limits contributions to a formula based upon a comparatively low salary.

In another respect, too, S. 1910 is more equitable than the present law. One factor in determining the amount of the exclusion allowance is years of service with an employer. Generally, the greater the number of years of service, the greater is the percentage of salary that can be contributed. When the number of years of service is small, the exclusion allowance is small. The Internal Revenue Service, however, has interpreted years of service to mean those with the employee's present employer. Our rabbis and lay persons do not have stationary careers. They move about from employer to employer within our faith. Whenever they change jobs, years of service for the exclusion allowance starts all over at the number one. The result may be different in a hierarchical denomination. This difference underscores the inequity of the law. In such denominations, the church governing body is generally considered to be the employer even though the employer, in fact, is a local unit of the church.

S. 1910 would deem all years of service of a minister or lay employee within his or her denomination as years of service for one employer. This rule would provide us with flexibility in that the diminution of retirement benefits would not ordinarily be a consideration in deciding whether we should or should not change jobs. All denominations, both hierarchical and congregational, should be treated in the same way for purposes of years of service.

Another feature of S. 1910 corrects a particularly unfair provision in the present law because it affects most adversely those clergymen who have assumed the greatest burdens. As you undoubtedly know, many denominations send missionaries into foreign lands to propagate the faiths. These missionaries often are paid very little, their compensation being largely their living quarters and subsistence. Since both the exclusion allowance and the 25-percent limitation are based upon a percentage of compensation, only small contributions can be made to their retirement annuities. These missionaries would like to retire in America. They return here to a country with high living costs and discover that they have no means on which to retire. S. 1910 would help the very worst-paid minister or lay employee. A provision in S. 1910 would treat a minister or lay employee as having a certain minimum compensation for purposes of the exclusion allowance. This compensation is measured by the poverty guidelines issued by the Office of Management and Budget.

Mr. Chairman, S. 1910 and similar bills have been pending in the Congress since 1978. We have waited a long time for the relief that we consider now due us. We urge you and your colleagues to do all you can to see that S. 1910 is made law this session of Congress.

I thank you for giving me this opportunity to appear before you and present our views on S. 1910.

Summary of Principal Points

1. Section 403(b) annuities are almost the exclusive means of providing retirement benefits for Jewish religious organizations, synagogues, schools, theological seminaries, and agencies.
2. The compensation of our clergy and lay employees has been traditionally low. The 25-percent-of-compensation limitation of Section 415(c) of the Internal Revenue Code prevents adequate catch-up contributions to the pensions of our rabbis and lay employees.
3. S. 1910 would give our rabbis and lay employees the same right to make catch-up contributions that employees of educational organizations, hospitals, and some health service agencies now have in Section 415(c)(4).
4. In other respects, S. 1910 would improve the retirement pensions of our rabbis and lay employees by: permitting *de minimis* contributions to avoid complicated calculations; by counting all years of service within one denomination so that when we change jobs, our past service credit is not eliminated; and deeming a certain compensation so that contributions can be made to the retirement annuities of our very worst-paid rabbis and lay persons.

STATEMENT OF GORDON E. SMITH, ASSISTANT DIRECTOR AND TREASURER, THE MINISTERS & MISSIONARIES BENEFIT BOARD, AMERICAN BAPTIST CHURCHES, NEW YORK, N.Y.

Senator CHAFEE. Reverend Smith.

Mr. SMITH. My name is Gordon Smith. I am the associate director and treasurer of the Ministers and Missionaries Benefits Board of the American Baptist Churches which is composed of approximately 6,000 churches and about a million and a half members. Our organization was established by the American Baptist churches in 1911 to provide a variety of benefits for ministers and missionaries. Currently, we provide these benefits for approximately 11,000 active, inactive, and retired, ordained, and lay members who serve American Baptist churches and related institutions.

On their behalf, I encourage the support of S. 1910. I have two concerns that I wanted to address. Both of them were referred to briefly in earlier testimony.

The first is personal. I am an ordained minister. And for 30 years, I have served my denomination, the American Baptist Churches. I have been with four employers. I am currently with the fourth, and I am in the sixth year of employment with my present employer. The present formula for determining the amount I can contribute to my annuity on a tax deferred basis defines years of service as those with the current employer. Therefore, I am denied credit for 24 years of service prior to my present appointment. My family responsibilities have lessened and I can now commit more of current income to catch up with many years of smaller contributions to my retirement account. S. 1910 will provide that opportunity for me and for thousands like me. And we are delighted to know that Treasury is supportive of that provision in S. 1910.

The second concern has to do with the future of the church pension board that I represent and many like ours. And this was referred to in Senator Bentsen's opening remarks. Congress passed legislation in 1980 which acknowledges these boards as appropriate vehicles to fund and administer annuities for members of church plans. Revenue Ruling 82-102 issued Monday appears to conflict with the intent of Congress in enacting this legislation.

We appreciate the willingness of Treasury and IRS to work with us in resolving problems created for us by this ruling. However, the ruling itself demonstrates the urgency of early passage of S. 1910. This bill will put to rest once and for all questions related to the intent of Congress in recognizing that church pension boards can issue 403(b) annuities.

The 11,000 members of plans sponsored by American Baptists are grateful for your willingness to consider our concerns and the way they can be resolved by the enactment of S. 1910. We respectfully encourage your support and leadership to secure the early passage of this legislation.

Thank you.

Senator CHAFEE. Thank you very much.

[The prepared statement follows:]

Senate Finance Committee
Hearings on S. 1910
May 17, 1982

Statement of Rev. Hugh D. Pickett on behalf of
The American Baptist Churches in the U.S.A.

My name is Hugh Pickett. I am appearing on behalf of the American Baptist Churches. We welcome the opportunity to appear before you to explain the importance of this bill to our denomination.

The American Baptist denomination consists of approximately 6,000 local churches and affiliated organizations throughout the United States. The denomination is congregational in nature in that each of the local organizations is separate, independent and autonomous. There are approximately 1,500,000 members of the local churches of the denomination.

The Ministers and Missionaries Benefit Board of American Baptist Churches was established by the American Baptist denomination in 1911 to provide for the better maintenance of the ministers and missionaries (and their families) who carry on the denomination's work. The Board, which was incorporated by special act of the New York legislature in 1913, has always been an integral part of the American Baptist denomination.

Among its other functions the Board maintains retirement annuity programs under section 403(b) of the Internal Revenue Code for over 11,000 active, inactive and retired ministers, missionaries and lay employees of the local congregations and agencies of the American Baptist denomination throughout the world. The Board's assets are professionally managed in accordance with the highest fiduciary standards applicable to organizations of its type under New York law. The reports of the Board's operations, as audited by its independent certified public accountants, are regularly provided to the participants and the governing bodies of the denomination and are available to other interested persons. Separate accounts are maintained under the Board's retirement annuity programs for the contributions made on behalf of each participant. All participants are fully vested in their benefits from the date contributions are made and all benefits are fully funded.

I am here today to voice the strong support of the American Baptist Churches for the passage of S. 1910. As indicated below, we believe this bill will continue the process begun by Congress in 1980 when it enacted legislation that made permanent the exemption from ERISA for church plans established by conventions or associations of churches and their agencies.

S. 1910 would build upon this process in two important ways. First, it would remove technical obstacles that now make it difficult for ministers and missionaries to accumulate the funds needed to provide an adequate retirement benefit. Second, it would eliminate questions that have recently arisen concerning the authority of church pension boards to provide section 403(b) retirement annuities, notwithstanding the fact that our Board has done this for seventy years.

Failure to adopt this legislation would impact upon those least able to bear the consequences - the ministers, missionaries and lay employees of churches who have little opportunity during their working careers to accumulate assets from which to provide retirement income.

A number of the provisions of S. 1910 deal with the ability to make so-called "catch-up contributions" for plan participants late in their careers. This is especially important because most participants in the church retirement plans are unable to set aside amounts to supplement their retirement incomes until late in their careers.

Compensation paid to ministers and other church employees depends upon donations from the local congregations. As a result, most ministers typically spend the greater part of their careers earning small salaries. During years of employment as a missionary, compensation is even lower. Only after ministers have been working for 25 or 30 years, when their family obligations have diminished, are they in a position to set aside any significant amounts under salary reduction arrangements that are allowed under section 403(b). The ability to make catch-up contributions at that time is vital, but is severely limited because of the present restrictions under section 403(b) and section 415.

One of the problems is that most American Baptist ministers serve several Baptist churches or agencies during their careers. At present, the Internal Revenue Service treats each church or agency as a separate employer for purposes of section 403(b), with the result that only service at the most recent assignment may be counted in determining the exclusion allowance. S. 1910 remedies this problem by providing that all service performed for a church or an association or convention of churches would be treated as service for a single employer for purposes of determining the section 403(b) exclusion allowance. Congress acknowledged the special nature of the employment relationship that exists in congregational denominations when it legislated in 1980 to permit church plans to cover the employees of any church or affiliated organization within the denomination. S. 1910 extends this definition of employment for purposes of determining the amount of the section 403(b) exclusion allowance.

However, this action alone would not permit significant increases in catch-up contributions unless section 415 were also liberalized at the same time by making available to church employees the same "catch-up" elections that are already permitted in section 415 for employees of educational organizations, hospitals and home health service agencies. S. 1910 would accomplish this result.

S. 1910 also provides that neither the 25% limitation nor the alternative catch-up elections under section 415 would have to be considered with respect to an annual contribution of $10,000 or less. (This amount would be adjusted for inflation.) The *de minimis* exemption for small annuity contract contributions is similar to an exemption already provided under section 415 for corporate defined benefit plans and its enactment would avoid the need to consider the complicated section 415 limitations in the case of small contributions.

S. 1910 would also end the uncertainty that has recently arisen as to whether section 403(b) annuities can be provided only by licensed insurance companies. As previously noted, our Board has been providing retirement annuities for Baptist ministers and lay employees for many decades, although we are not a licensed insurance company. The same is true of numerous other church pension boards. For many years the IRS ruled that these annuity contracts may qualify under section 403(b). However, very recently the IRS appears to have changed its position and now contends that only contracts issued by licensed insurance companies can be treated as section 403(b) annuity contracts. There is no basis for this position as applied to church plans, and S. 1910 would make this clear.

When Congress defined church plans in 1980, it recognized that church pension boards are acceptable funding media for church plans of all types, and Internal Revenue Code section 414(e)(3)(A) specifically states that a church plan ". . . includes a plan maintained by an organization . . ., the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, . . ." The legislative history of this section makes clear that Congress was well aware of the prevalance of section 403(b) church annuity arrangements at the time it enacted this provision.

Finally, S. 1910 would recognize the need for a grace period to permit church plans to continue to operate in their traditional fashion until any technical questions that may arise in the future can be definitively resolved.

In summary, we respectfully urge favorable consideration and the ultimate passage of S. 1910 to provide needed relief to ministers and missionaries and lay church employees throughout the United States and to protect the importance and unique function of church plans.

STATEMENT OF REV. LAWRENCE A. WASHBURN, PASTOR, PEACE DALE CONGREGATIONAL CHURCH, PEACE DALE, R.I.

Senator CHAFEE. Reverend Washburn of Rhode Island.

Reverend WASHBURN. Senator Chafee and Senator Bentsen, I am concerned about the time and I hope you will be able to stay an extra 5 minutes to hear the whole panel.

Senator CHAFEE. I will stick it—not stick it out. [Laughter.] I will remain.

Reverend WASHBURN. I am the pastor of the Peace Dale Congregational Church serving the towns of South Kingstown and Narragansett, R.I. I have a doctorate of minister degree. And I represent also the ministers of our conference as a former president of the Ministers Association, and former president of the Conference.

The United Church of Christ is a denomination of approximately 6,000 congregations with about 8,000 clergy employees, both lay and clergy. It has a long history in our country. The Congregationalist came from the Pilgrim and Puritan merger back in the 1640's. We've been closely identified with the history of our country in founding such institutions as Yale, Harvard, and Dartmouth.

As a member of the annuity fund—a clergy member of the annuity fund—it is very important to me that our church continue to be allowed to do what it has historically done in providing annuities for its ministers.

The ministry is not the profession you go into if you want to make a lot of money. I started out at a salary of $2,500 back in 1956. And currently the average minister makes between $12,000 and $15,000 a year plus housing. S. 1910 allows catchup contributions to provide for adequate pension in their later years as they approach retirement. S. 1910 also will correct an unfair situation which counts our time employed with each particular church rather than as time in the denomination. When I was ordained, I was ordained to the United Church of Christ. And my time and service should be counted from the time I am ordained until the time I retire.

I am also concerned that this bill will help our missionaries who may be serving in Africa or other such places who are earning perhaps $5,000 a year because that is all it takes to live there. This will allow the mission boards to contribute an amount to their pensions so that when they retire back in the States, they can have an adequate salary.

And, lastly, it's just my belief that churches do things better than most institutions. And I believe that our pension boards are being run and managed in such a way that we get a better buy at less cost. So I am in favor of S. 1910.

Thank you.

Senator CHAFEE. There is one question that I had. Do I understand it? In S. 1910 you must stay in the same congregation or denomination?

Reverend WASHBURN. Right. You have to be in the same denomination. But right now our time is only counted in a particular church.

Senator CHAFEE. But suppose you change denominations? Suppose an Episcopalian becomes a Catholic or vice versa? Does he lose out?

Mr. NASH. They get to start over then.

Senator CHAFEE. Is that any kind of a problem? Don't choose that particular situation.

Reverend WASHBURN. That's not a problem to us. We are concerned about the people within the same denomination who have their time counted within that denomination.

[The prepared statement follows:]

SUMMARY OF STATEMENT OF REV. LAWRENCE A. WASHBURN IN SUPPORT OF S.1910

The proposed legislation is desirable because:

1. It provides the same limitations on annual contributions to annuity plans for all ministers and lay employees of a church or denominational agency without regard to whether the plan participant is a member of a congregational denomination or a hierarchical denomination.

2. It eliminates the unfair basis upon which ministers and lay employees of Churches have been excluded from the right to claim special exceptions under section 415 of the Code.

3. It affords a de minimis contribution level for those whose normal compensation would not provide an annual contribution capable of affording adequate retirement income.

4. Those laboring in foreign missions at extremely low compensation are provided with an opportunity to obtain respectable retirement benefits through the creation of a minimum compensation level for purposes of computing contributions.

5. It eliminates the need to lump contributions to a forfeitable annuity in the year when such annuities become non-forfeitable, thereby insuring plan participants of the right to the special elections or the de minimis contribution amount.

6. It recognizes the right of a church or a convention or association of churches to provide annuity contracts.

96-536 O - 82 - 12

STATEMENT OF REV. LAWRENCE A. WASHBURN, PASTOR OF PEACE DALE CONGREGATIONAL CHURCH OF THE UNITED CHURCH OF CHRIST, PEACE DALE, RHODE ISLAND, DELIVERED ON MAY 17, 1982, BEFORE THE SENATE FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, IN SUPPORT OF S. 1910

Mr. Chairman, and members of the Subcommittee, my name is Lawrence A. Washburn and I appear before you to speak in support of Senate bill S.1910. I am an ordained minister of the United Church of Christ, and I am presently serving as Pastor of the Peace Dale Congregational Church of the United Church of Christ in Peace Dale, Rhode Island.

I hold the degree of Doctor of Ministry. In addition to having served congregations in a pastoral rôle during my ministry, I am the former President of the Rhode Island Conference of the United Church of Christ, the membership of which consists of local churches of the United Church of Christ located in Rhode Island, and local ministers having standing in the denomination. Also, I served as President of the Ministers Association of Rhode Island, a group of ministers of the United Church of Christ in Rhode Island having common interests and concerns.

As an extension of the mission of my church, I have become involved in low income housing for the elderly and thus possess a first hand knowledge regarding the problems facing retired persons in general, and as a result of my work with ministers, I am particularly familiar with those problems as they relate to retired members of the clergy.

I can assure you, Mr. Chairman and members of this Subcommittee, that we ministers and those lay persons employed by churches or agencies of denominations, are no different from our brothers and sisters in other callings. We share the same frailities. We have the same temporal needs. We, as is the case with others, must accept the inevitability of the infirmities of age, and we share a common hope that we can live out our final years in dignity and with some measure of security. Indeed, it is this latter concern that prompts my appearance before you today.

Before considering the proposed legislation, let me tell you something of the church or fellowship to which I belong and which I have served since 1959. The United Church of Christ is a product of the merger in 1957 of the Congregational Christian Churches and the Evangelical and Reformed Church. It has approximately two million members, worshiping in close to six thousand local churches across the country. It has a full evangelical mission program, both at home and abroad. Of significance to this Subcommittee and a fact which has great relevance to the proposals to which I speak is the circumstance that the United Church of Christ is congregationally organized as opposed to a hierarchical organization, and as such, each of its local congregations is autonomous. I shall address this point in some detail, later in my testimony.

Since my ordination in 1959, I have been a member of the Annuity Fund for Ministers which is an instrumentality within the United Church of Christ, charged with the responsibility of providing retirement benefits for ministers, their spouses and dependents. Another organization known as the Retirement Fund for Lay Workers provides similar benefits for the lay employees of the churches and instrumentalities of the denomination. The retirement benefits provided by these organizations are derived from tax sheltered annuity plans managed in accordance with the provisions of Section 403(b) of the Internal Revenue Code. Contributions are made to members accounts by the employing organization and to the extent possible by the members themselves. Upon retirement, the accumulations are used to provide an annuity for the benefit of the member. Because the proposed legislation relates to the rules governing such annuities, and therefore directly affects the retirement income available to members of such plans, my interest and that of my colleagues is evident.

One of the key provisions of the proposed legislation undertakes to correct an inequity in existing legislation which restricts the right of ministers of a congregational denomination to make catchup contributions, so as to provide an adequate retirement income. Catchup contributions are essential if ministers are to be protected in retirement. Ministers in comparison with those in other professions, have been historically underpaid. In their early years, ministers are subject to the same demands as those outside the ministry. They are engaged in the process of raising families and educating them, all of which places a drain on already limited resources, and leaves but a bare minimum, if anything for contributions to a plan over and above those made by the employer. The time then, to make the contributions necessary to afford adequate retirement benefits is when such obligations no longer exist and ministers can devote more of their spendable income for pension purposes.

A minister in a congregationally organized denomination, may have extra funds available at such time for contributions to a plan, but under current law the years of service factor of the exclusion allowance is limited to years of service with the minister's employer at the time the contribution is made. Ministers make changes during the course of their ministry and a minister of a congregational denomination is given no credit for past services with other churches or employers in the denomination. It is readily apparent that this factor severely reduces the exclusion allowance and the ability of a minister of a congregational denomination to make catchup contributions. Such an artificial limitation does not exist with respect to ministers of hierarchical organizations where all service within the denomination is treated as service to one employer, despite the fact that the minister may have served a number of churches or agencies.

In the legislation before you it is proposed to treat employment of a minister by any number of churches or agencies in a congregational denomination as service for a single employer and all years of such service rendered by a minister would be aggregated in determining the exclusion allowance for taxable years. Such a rule will eliminate the obvious inequity resulting solely from an accident of church polity.

Of equal importance to ministers and lay employees, not only of congregational denominations but of all denominations are the proposed amendments to Section 415 of the Internal Revenue Code. This section contains certain rights of election by which employees of educational organizations, hospitals and home health service agencies may make contributions in excess of the limitations provided for others. These limitations restrict annual contributions for others to a plan participant's account to the lesser of $25,000 or 25% of the participant's compensation. The rationale for providing the right to elect contributions in excess of such limitations for employees of the favored organizations was that such employees were identified as being in low paying positions. Unfortunately, in doing so the Congress overlooked the plight of ministers and lay employees of churches who as a group are more poorly compensated than most segments of our society. Simple justice requires that this wrong be righted. The proposal before you corrects these inequities in several ways:

(a) It makes available the election to exceed the $25,000 or 25% limitation contained in Section 415(c)(4) to employees of church denominations and their agencies.

(b) It provides for a de minimis contribution of $10,000 which may be made without regard to the 25% limitation or the elections under Section 415(c)(4). In other words, members of the protected groups would now, subject to the exclusion allowance, be guaranteed the right to make a contribution of at least $10,000 without any adverse tax consequences. This would be of substantial value to the ministers, and there are many of them, whose annual contribution if limited to the lesser of $25,000 or 25% of compensation could never achieve the contribution level of $10,000 per annum.

(c) Annual contributions to a Section 403(b) annuity at a time when it is forfeitable are treated the same as annual contributions to a non-forfeitable annuity and are deemed received in the year for which payment is actually made rather than lumped together in the year the contract becomes non-forfeitable. This result is in keeping with the rules presently applicable to qualified defined contribution plans and assures that the elections provided for under Section 415 will not be lost by reason of attributing several years of contributions to a single year.

Ministers working in the foreign missions are normally compensated at a rate below even that of their brothers in the United States. Most of these individuals, nevertheless, plan to retire within the United States but the paucity of their income prohibits adequate planning for retirement needs. To some extent, Section 3 of S.1910 alleviates this situation by defining includible compensation to be not less than twice the nonfarm income poverty guidelines of a family unit of four, which resides in the continguous United States for the prior taxable year. This standard of includible compensation affords the minister engaged in foregin service or at an unreasonably low income to at least make or have made on his behalf contributions based upon an amount of compensation which will afford minimum protection for retirement years.

I also view with favor the Section of the proposal which clarifies any ambiquity that may exist under the present law as to the right of a church plan to provide an annuity contract. While this right has been historically, recognized in IRS rulings, the Internal Revenue Service has in recent years expressed the possibility of limiting 403(b) annuities to those issued by a licensed insurance company. The right of a church pension board to issue any annuity needs to be expressed in the statute because any requirement to provide annuities through insurance companies or other agencies outside the church could only lead to higher costs and resultant smaller benefits to ministers and lay employees.

I urge favorable action by the Subcommittee on this legislation because it corrects the manifest injustice in the present law, which excludes ministers and lay employees of churches and denominations from the special treatment afforded other groups, who for the most part enjoy higher earnings, and because it places all ministers and lay employees of denominations on the same footing regardless of peculiarities of church polity.

STATEMENT OF HAROLD A. CLARK, MANAGER, PENSIONS AND BENEFITS, BOARD OF PENSIONS OF THE UNITED PRESBYTERIAN CHURCH IN THE U.S.A., PHILADELPHIA, PA.

Senator CHAFEE. Mr. Clark.

Mr. CLARK. Thank you, Senator. My name is Harold A. Clark, and I am the benefits manager for the United Presbyterian pension and benefits plan, which is administered by the board of pensions of the United Presbyterian Church on behalf of our 8,832 local churches, and the more than 2,434,000 members of our denomination.

It may be of interest to your committee that the United Presbyterian pension and benefits plan is considered to be one of the oldest retirement plans in the United States. Our predecessor plans go back to the 1700's.

The present plan, which began in 1927, is generally regarded as being one of the most securely funded retirement plans in this country.

I am here to urge the passage of S. 1910. And, particularly, provisions for an administrative forbearance period. The legislation before you includes such an administrative forbearance period. This administrative forbearance provision is for both tax qualified and deferred annuity church plans.

It is similar in concept to section 414(e)(4). The reason for the need for an administrative forbearance period for church plans, as Senator Bentsen referred to earlier, is that most churches cannot act quickly in making plan amendments. The administrative forbearance period would provide adequate time for churches to consider any amendments which may be proposed. It would also recognize such plans as meeting the requirements of tax qualified or deferred annuity plans during the forbearance period. Likewise, the administrative forbearance period would permit the Internal Revenue Service to properly administer the provisions of the Internal Revenue Service Code in regards to tax qualified and deferred annuity plans while recognizing at the same time the unique nature of these plans.

Finally, it would allow adequate time for the consideration of any legislation which may be desirable. It would also permit the Internal Revenue Service to consider questions related to church plans without being forced to take adverse action against ministers and other plan participants. It is a genuine concern that such an action might adversely affect the benefits of our plan members and their families before our normal plan amendment process, which in our process can take 2 or 3 years, can accomplish remedial changes.

Enactment of S. 1910 with the administrative forbearance period will ease this concern and allow time for appropriate legislation and/or plan amendments. This will enable our plan members to enjoy the same sense of security with regard to their future plan benefits as they have enjoyed during the long history of their pension and benefits plan.

I thank you for the opportunity to present this statement on behalf of S. 1910 and the forbearance period.

Senator CHAFEE. That was very well expressed, Mr. Clark.

[The prepared statement follows:]

The Board of Pensions

A part of the Vocation Agency
of the United Presbyterian Church in the United States of America

1834 ARCH STREET · PHILADELPHIA PA 19103

WRITER'S DIRECT DIAL NUMBER 215/963-1100

SENATE FINANCE SUBCOMMITTEE ON
SAVINGS, PENSIONS AND INVESTMENT
POLICY HEARING ON S. 1910

May 17, 1982

STATEMENT ON BEHALF OF THE BOARD OF PENSIONS
OF THE UNITED PRESBYTERIAN CHURCH IN THE U.S.A.

The Church consists of approximately 8,832 local churches and affiliated organizations throughout the United States. There are approximately 2,4[illegible]4,000 members of the local churches of the United Presbyterian Church.

The United Presbyterian Church in the U.S.A. supports S. 1910.

We note in particular Section 11 of the bill that provides for a "period of administrative forbearance" that would be applicable to both tax-qualified and deferred annuity church plans. An administrative forbearance period would provide adequate time for churches to consider any amendments which may be proposed. It would also recognize such plans as meeting the requirements of tax-qualified or deferred annuity plans during the forbearance period.

Likewise, the administrative forbearance period would permit the Internal Revenue Service to recognize the unique nature of these plans, and it would allow adequate time for consideration of any additional legislation which may be desirable. It would also permit the Internal Revenue Service to consider questions relating to church plans without being forced to take adverse action against ministers and other plan participants.

In conclusion, the United Presbyterian Church reiterates its support of S. 1910 for the aforementioned reasons and encourages its expeditious enactment.

STATEMENT OF GARY S. NASH, GENERAL COUNSEL, ANNUITY BOARD OF THE SOUTHERN BAPTIST CONVENTION, DALLAS, TEX., AND SECRETARY, CHURCH ALLIANCE FOR CLARIFICATION OF ERISA, WASHINGTON, D.C.

Senator CHAFEE. Now Mr. Nash.

Mr. NASH. Thank you, Senator Chafee. I am Gary Nash, general counsel and secretary of the annuity board of the Southern Baptist Convention. The annuity board of the Southern Baptist Convention was chartered in Texas in 1918 to provide relief and annuity benefits to ministers and other denominational workers within the bounds of the Southern Baptist Convention. It is headquartered in Dallas. Dr. Darold Morgan, a Baptist minister, is its president. On behalf of Dr. Morgan and myself and other Southern Baptists, we want to express our appreciation to you, Senator Chafee, for scheduling these hearings today; to Senator Bentsen, and to Senator Dole for the sponsorship of this urgently needed legislation.

The annuity board is represented on the church alliance for clarification of ERISA that is composed of members of over 27 religious denominations acting on behalf of their pension programs. On behalf of the church alliance, we would encourage your support of S. 1910, and we would stress the urgency of immediate passage of S. 1910 in light of Revenue Ruling 82-102.

With respect to the vesting provision in the bill, which the Treasury said they opposed—that concerns section 403(b)(6) of the Code—it is our understanding that the Internal Revenue Service has informally advised lawyers that the interpretation given to section 415 that is embodied in S. 1910 is the correct interpretation. That is, that annual contributions to an annuity account would be considered annual additions for purposes of section 415 in the year actually made, rather than in the year they become nonforfeitable.

We are somewhat surprised that the Treasury opposes this section, which statutorily recognizes the interpretation we understand has been informally the position of the IRS for some time.

We want to thank you very much for your consideration of S. 1910.

Senator CHAFEE. Thank you very much, Mr. Nash, for that fine statement.

[The prepared statement follows:]

TESTIMONY OF GARY S. NASH
IN SUPPORT OF
S. 1910

Finance Subcommittee on Savings, Pensions and Investment Policy
Senate Finance Committee

My name is Gary S. Nash, and I am the secretary of the Church Alliance for Clarification of ERISA ("CACE"). I am also general counsel and secretary of Annuity Board of the Southern Baptist Convention, 511 North Akard, Suite 311, Dallas, Texas 75201. CACE was formed for the purpose of clarifying certain portions of the Employee Retirement Income Security Act of 1974 ("ERISA"). As of the date of this hearing, there are 27 church denominations participating in CACE. S. 1910, a bill introduced by Senators Bentsen and Dole, is to amend certain sections of the Internal Revenue Code of 1954 ("CODE") that affect retirement programs established or maintained by church pension boards.

S. 1910 is composed of 12 sections, and I will briefly discuss each section so this subcommittee will have a better understanding of the technical and policy considerations that underlie each provision in the bill:

Section 1 and Section 6: Sections 1 and 6 of S. 1910 amend Code § 403(b)(2)(B) and § 415(c)(4) to make the special "catch-up" exceptions to the contribution limits set out in Code §415 available to employees of churches, conventions or associations of churches and certain related organizations described in Code § 414(e)(3)(B)(ii). The "catch-up" exceptions which are part of existing Code § 415 were added to the Code to allow employees of educational institutions, hospitals and home health service agencies to make greater annual contributions to their respective retirement programs than those normally provided for under the general rules of Code § 415. Congress saw fit to add these exceptions in view of the fact that employees of the three types of organizations described above were historically poorly compensated in their early working years, while being prevented from making affordable contributions in later working years due to the general contribution limits imposed by Code § 415. The same state of affairs (i.e., low compensation until late years of employment) exists for ministers and lay denominational employees, perhaps even to a greater extent, and the special exceptions that will be provided through S. 1910 in Code § 403(b)(2)(B) and § 415(c)(4) are therefore much in need by this classification of employees.

Section 2: Section 2 of S. 1910 adds a new subparagraph (C) to Code § 403(b)(2). Under present law, whenever an employee goes to work for a new non-profit employer, contributions made by that employer toward the purchase of additional tax sheltered annuity benefits are treated as purchasing a new § 403(b) annuity contract for the employee, and years of service with the employee's prior employer do not count as years of service for the new employer for § 403(b) purposes. This rule penalizes a denominational worker who works for several employers within his or her denomination by decreasing the non-taxable retirement contribution which can be made on his or her behalf. This result is especially pronounced in the typical situation of no or low contributions in early years of employment with larger contributions in later years. The rules described above also impose a tremendous administrative burden on church pension boards which maintain tax sheltered annuity programs due to the large number of intra-denominational transfers which take place over the working lives of denominational personnel. If enacted, Section 2 of S. 1910 will treat all of a minister's years of service within his or her denomination as service on behalf of one employer, thus resulting in the purchase of only one 403(b) annuity contract. This change in the law will result in a great deal of simplification for ministers and lay employees covered by tax sheltered annuity programs, as well as enhancing their denomination's ability to provide for their retirement years when salary levels have finally risen to a level which will support meaningful retirement contributions.

Section 3: Section 3 of S. 1910 will amend § 403(b)(3) by providing a basis for a minimum tax sheltered annuity contribution for every denominational employee. Section 3 accomplishes this end by establishing a floor for an employee's "includible compensation" that is taken into account in computing that employee's non-taxable retirement contribution. The floor used in Section 3 is the non-farm income poverty guideline for a family unit of 4 residing in the contiguous United States for the preceding taxable year. This guideline is established annually by the Office of Management and Budget for programs under which the poverty line is a criterion of eligibility. Many ministers and missionaries are terribly underpaid, and Section 3 takes this fact into account by allowing a more meaningful retirement contribution to be made on their behalf. Tying minimum "includible compensation" to the poverty guideline described above will prevent any abuse from occurring in this area.

Section 4: Section 4 of S. 1910 is designed to clarify that a church pension board can provide annuity benefits covered by Code § 403(b). The Internal Revenue Service has ruled that a state teachers' retirement fund and a separately incorporated fund of a tax-exempt organization can issue annuity contracts covered by Code § 403(b), and Section 4 of S. 1910 will make it clear that this same rule applies to annuity contracts issued by churches, conventions or associations of churches and certain related organizations providing annuity benefits to denominational personnel.

Section 5: Section 5 of S. 1910 is designed to put tax sheltered annuity plans described in Code § 403(b) on a par with qualified retirement plans with regard to the rules of taxation by constructive receipt. Prior to the enactment of the Economic Recovery Tax Act of 1981 ("ERTA"), a participant in a qualified plan could be held to have constructively received his or her retirement benefits, and required to pay tax thereon, if such benefits were "made available" to the participant, even though not actually received. In enacting ERTA, Congress decided to simplify taxation under qualified retirement plans and abolished this "made available" rule for taxable years beginning after December 31, 1981. Benefits payable from qualified plans are now taxable only when actually received. The members of CACE believe the same treatment should be extended to § 403(b) annuity contracts, and Section 5 achieves this result.

Section 7: Section 7 of S. 1910 amends the Code by adding a new subparagraph (8) to Code § 415(c). Subject to the overriding exclusion allowance limitation of Code § 403(b), this new subsection (8) will permit certain non-profit organizations (including churches) eligible to purchase 403(b) annuities to contribute a minimum of $10,000 per year toward the purchase of such annuity for each of their employees not withstanding the general limits imposed by Code § 415(c). The members of CACE deem a $10,000 annual contribution as a de minimis amount when viewed against the backdrop of the extremely low retirement contributions which historically have been made on behalf denominational personnel. The $10,000 minimum contribution amount will ensure that a minister or missionary will have some provision for their retirement years even if their compensation level never rises to a point where the "catch-up" exceptions of Code § 415(c)(4) can be of assistance. This state of affairs currently exists, and the members of CACE expect it will continue to exist in the future.

Section 8: Section 8 of S. 1910 amends § 415(c) of the Code in order to eliminate a technical problem that exists only with respect to § 403(b) annuity contracts. As noted earlier in my testimony, Code § 415 limits the amount that can be contributed toward the purchase of a tax sheltered annuity contract in each year. This limitation creates a problem for tax sheltered annuity programs that contain a vesting feature permitted by Code § 403(b)(6). Section 403(b)(6) recognizes that amounts contributed to purchase tax sheltered annuity benefits can change from forfeitable to nonforfeitable status, and under § 403(b)(6) the change is treated as a tax sheltered annuity contribution made during the year in which the change occurs. Section 415(c) does not take this special § 403(b) "pour-over" rule into account. Section 8 of S. 1910 will correct this situation by allowing "pour-over" contributions to be made toward the purchase of tax sheltered annuity contracts, notwithstanding the general contribution limitations of § 415(c).

Section 9 and Section 10: Under present law, the contribution and benefit limitations set out in Code § 415 increase under procedures which are similar to those used to adjust primary insurance amounts under § 215(i)(2)(A) of the Social Security Act. As noted earlier, Section 7 of S. 1910 amends Code § 415 to provide for a minimum tax sheltered annuity contribution of $10,000 per year, and Sections 9 and 10 of the bill provide that this $10,000 amount is to be adjusted in the same manner as regular retirement contributions subject to § 415(b) and § 415(c). Section 10 provides that this adjustment procedure is to be retroactively effective to October 1, 1974, a date very close in time to ERISA's enactment. I am sure Congress is well aware of the ravages wrought by inflation, and we believe that the $10,000 minimum contribution provision needs to be sensitive to this fact of 1980's life.

Proposed Section 11: Church plans exist in several forms: § 403(b) tax sheltered annuity programs, plans covered by the post-ERISA requirements imposed on qualified plans and so-called "non-electing" church plans covered by the qualified plan rules as they existed prior to ERISA's enactment. A number of complex legal rules apply in each area, and church pension boards have been struggling since ERISA's enactment to find out exactly where their church plans fit into the Code. I think most practitioners will agree that answering this question has not been an easy task. Section 11 of S. 1910 provides for a new Code § 414(n) which establishes a period of administrative forbearance for church plans. Under new subsection (n), a church plan which is notified by the Secretary of the Treasury that its retirement program is deficient in some respect will have a minimum period of 270 days to correct these deficiencies without penalty. Enactment of new Code § 414(n) is intended to ensure that problems can be corrected fairly and in an orderly fashion without penalizing the people who need the period of administrative forbearance the most - the ministers and other denominational employees church plans serve.

Section 11 (proposed Section 12): Deals with effective dates.

CONCLUSION

Mr. Chairman, church plans that are tax sheltered annuity arrangements are in great need of the reforms provided by S. 1910. All church plans will benefit from the administrative forbearance provision of Section 11 of this bill. Ministers and denominational employees will be greatly benefitted by the increased economic security which S. 1910's enactment will make available. I am most grateful to have the opportunity to appear before this subcommittee and I would like to publicly thank you for the attention and courtesy you and your staffs have shown me and the members of CACE during S. 1910's consideration.

Senator CHAFEE. Gentlemen, as you know, this is a matter of considerable concern. And with the distinguished sponsors of this bill—Senator Bentsen and Senator Dole—I assure you that we will get right to it. And as Mr. Glickman from the Treasury Department indicated, they will be consulting with Senator Bentsen's and Senator Dole's staff on this.

Thank you all for coming.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT

OF

BILLY GRAHAM EVANGELISTIC ASSOCIATION

RE:

S.1910

In 1958 Congress extended the provisions of tax sheltered annuities (26 U.S.C. §403) to include employees of 26 U.S.C. §501(c)(3) organizations which are exempt from tax under Section 501(a). From 1958 to the present, these employees have benefited from the tax benefits as conferred upon them by Congress. However, only educational institutions, hospitals and home health service agencies have had the additional benefit of alternative exclusion allowances for computing contributions to tax sheltered annuities. Other 26 U.S.C. §501(c)(3) organizations. have not had this benefit.

The amendments to Chapters 403 and 415 of the Internal Revenue Code of 1954 contemplated by S.1910 will provide the employees of churches and associations of churches with the same benefits presently enjoyed by educational institutions, hospital and home health service agencies. To this extent, these amendments are necessary and should be enacted. However, these amendments do not provide for equal tax treatment to the employees of religious organizations other than employees of churches and associations of churches. The amendments, therefore, are not broad enough to cure the prime defect in the existing Tax Sheltered Annuity Law; namely, disparity among the various tax exempt groups entitled to participate in tax sheltered annuities.

Billy Graham Evangelistic Association respectfully recommends that the Bill be amended prior to passage to read as follows:

A BILL

To amend sections 403(b)(2) and 403(b) of the Internal Revenue Code of 1954 with respect to computation of the exclusion allowance for employees of religious organizations; to add a new section 403(b)(9) to clarify that a section 403(b) annuity contract includes an annuity contract of a religious organization; to conform section 403(c) with recent amendments to section 402(a)(1); to amend section 415(c)(4) to extend the special elections for section 403(b) annuity contracts to employees of religious organizations, including churches or conventions or associations of churches and their agencies; to add a new section 415(c)(8) to permit a *de minimis* contribution amount in lieu of such elections; and to make a clarifying amendment to section 415(c) by adding a new paragraph (9) and conforming amendments to sections 415(d)(1), 415(d)(2), and 403(b)(2)(B).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 403(b)(2)(B) of the Internal Revenue Code of 1954 is amended to read as follows:

"(B) ELECTION TO HAVE ALLOWANCE DETERMINED UNDER SECTION 415 RULES.--In the case of an employee who makes an election under section 415(c)(4)(D) to have the provisions of section 415(c)(4)(C) (relating to special rule for section 403(b) contracts purchased by educational institutions, hospitals, home health service agencies, and religious organizations, including churches or conventions or associations of churches and organizations described in section 414(e)(3)(B)(ii) apply, the exclusion allowance for any such employee for the taxable year is the amount which could be contributed (under section 415 without regard to section 415(c)(8) by his employer under a plan described in section 403(a) if the annuity contract for the benefit of such employee were treated as a defined contribution plan maintained by the employer.".

SEC. 2. Section 403(b)(2) of the Internal Revenue Code of 1954 is amended by adding the following subparagraph:

"(C) NUMBER OF YEARS OF SERVICE FOR EMPLOYEES OF RELIGIOUS ORGANIZATIONS.--For purposes of this subsection, all years of service by an employee of a religious organization, including any employee of a church or a convention or association of churches or an organization described in section 414(e)(3)(B)(ii) of such church (or convention or association of churches) shall be considered as years of service for 1 employer, and all amounts contributed for annuity contracts by each such religious organization during such years for such employee, shall be considered to have been contributed by 1 employer. For purposes of the preceding sentence, the term 'church (or convention or association of churches)' shall have the same meaning as it does for purposes of section 414(e)."

SEC. 3. Section 403(b)(3) of the Internal Revenue Code of 1954 is amended by adding at the end the following sentence:

"Notwithstanding the preceding sentences, the includible compensation of an employee described in paragraph (2)(C) is not less than twice the nonfarm income poverty guideline of a family unit of 4 who resides in the contiguous United States for the prior taxable year in accordance with regulations prescribed by the Secretary. Such regulations shall provide for procedures to establish and revise the nonfarm income poverty guideline which are similar to the procedures used by the Office of Management and Budget for programs in which the poverty line is a criterion of eligibility.".

SEC. 4. Section 403(b) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(9) CERTAIN ANNUITY CONTRACTS.--For purposes of this subsection, the term 'annuity contract' includes an annuity contract provided by a religious organization, including a church or a convention or association of churches, and including an organization described in 414(e)(3)(A).".

SEC. 5. The last sentence of section 403(c) (relating to taxability of beneficiary under nonqualified annuities or under annuities purchased by exempt organizations) is amended by striking out "or made available".

SEC. 6. Section 415(c)(4) of the Internal Revenue Code of 1954 is amended to read as follows:

"(4) SPECIAL ELECTION FOR SECTION 403(b) CONTRACTS PURCHASED BY EDUCATIONAL ORGANIZATIONS, HOSPITALS, HOME HEALTH

SERVICE AGENCIES, AND RELIGIOUS ORGANIZATIONS, INCLUDING CHURCHES OR CONVENTIONS OR ASSOCIATIONS OF CHURCHES AND THEIR AGENCIES.--

"(A) In the case of amounts contributed for an annuity contract described in section 403(b) for the year in which occurs a participant's separation from the service with an educational organization, a hospital, a home health service agency, or a religious organization, including a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the amount of the exclusion allowance which would be determined under section 403(b)(2) (without regard to this section) for the participant's taxable year in which such separation occurs if the participant's years of service were computed only by taking into account his service for the employer, as determined for purposes of section 403(b)(2), during the period of years (not exceeding 10) ending on the date of such separation.

"(B) In the case of amounts contributed for an annuity contract described in section 403(b) for any year in the case of a participant who is an employee of an educational organization, a hospital, a home health service agency, or a religious organization, including a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the least of--

"(i) 25 percent of the participant's includible compensation (as defined in section 403(b)(3) plus $4,000,

"(ii) the amount of exclusion allowance determined for the year under section 403(b)(2), or

"(iii) $15,000.

"(C) In the case of amounts contributed for an annuity contract described in section 403(b) for any year for a participant who is an employee of an educational organization, a hospital, a home health service agency, or a religious organization, including a church or convention or association of churches or any organization described in 414(e)(3)(B)(ii), at the election of the participant the provisions of section 403(b)(2)(A) shall not apply.

"(D)(i) The provisions of this paragraph apply only if the participant elects its application at the time and in the manner provided under regulations prescribed by the Secretary. Not more than one election may be made under subparagraph (A) by any participant. A participant who elects to have the provisions of subparagraph (A), (B), or (C) of this paragraph apply to him may not elect to have any other subparagraph of this paragraph apply to him. Any election made under this paragraph is irrevocable.

"(ii) For purposes of this paragraph the term 'educational organization' means an educational organization described in section 170(b)(1)(A)(ii).

"(iii) For purposes of this paragraph the term 'home health service agency' means an organization described in subsection 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health and Human Services to be a home health agency (as defined in section 1861(o) of the Social Security Act).

"(iv) For purposes of this paragraph the term 'religious organization' means an organization described in subsection 501(c)(3) which is exempt from tax under section 501(a), contributions to which by the public are deductible under section 170(c)(2)."

"(v)" For purposes of this paragraph the term 'church or convention or association of churches' shall have the same meaning as it does for purposes of section 414(e).".

SEC. 7. Section 415(c) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(8) CERTAIN TOTAL ANNUAL CONTRIBUTIONS AND ADDITIONS

NOT IN EXCESS OF $10,000.--In the case of a participant who is an employee of a hospital, an organization described in paragraph (4)(D), or an organization described in section 414(e)(3)(B)(ii), notwithstanding any other provision of this subsection, contributions and other additions for an annuity contract described in section 403(b) with respect to such participant, when expressed as an annual addition (within the meaning of subsection (c)(2) to such participant's account, shall not be deemed to exceed the limitation of subsection (c)(1) if such annual addition is not in excess of $10,000.00.".

SEC. 8 Section 415(c) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(9) APPLICATION WITH SECTION 403(b)(6).--If the rights of an employee under an annuity contract described in subparagraphs (A) and (B) of section 403(b)(1) are forfeitable at the time any contribution is made to such contract and if the rights subsequently become nonforfeitable within the meaning of section 403(b)(6), this subsection applies to such contract as if the rights of the employee were nonforfeitable at such time.".

SEC. 9. Section 415(d)(1) of the Internal Revenue Code of 1954 is amended to read as follows:

"(1) IN GENERAL.--The Secretary shall adjust annually--

"(A) the $75,000 amount in subsection (b)(1)(A), "(B) the $25,000 amount in subsection (c)(1)(A),

"(C) in the case of a participant who is separated from service, the amount taken into account under subsection (b)(1)(B), and

"(D) the $10,000 amount in subsection (c)(8),

for increases in the cost of living in accordance with regulations prescribed by the Secretary. Such regulations shall provide for adjustment procedures which are similar to the procedures used to adjust primary insurance amounts under section 215(i)(2)(A) of the Social Security Act.".

SEC. 10. Section 415(d)(2) of the Internal Revenue Code of 1954 is amended to read as follows:

"(2) BASE PERIODS.--The base period taken into account--

"(A) for purposes of subparagraphs (A), (B), and (D) of paragraph (1) is the calendar quarter beginning October 1, 1974, and

"(B) for purposes of subparagraph (C) of paragraph (1) is the last calendar quarter of the calendar year before the calendar year in which the participant is separated from service.".

SEC. 11. The amendments made by sections 1, 3, 5, 6, 7, 9, and 10 of this Act shall be effective for taxable years beginning after December 31, 1980. The amendments made by section 2 of this Act shall be effective in determining the exclusion allowance under section 403(b)(2) for taxable years beginning after December 31, 1980. Years of service prior to January 1, 1981, and thereafter shall be aggregated in accordance with these amendments. The amendment made by section 4 of this Act shall be effective for all taxable years prior and subsequent to January 1, 1981. The amendment made by section 8 of this Act shall be effective for all taxable years prior and subsequent to January 1, 1981, except that the taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to have such amendment not be effective with respect to contributions made prior to January 1, 1981.

Respectfully submitted,

Geo. M. Wilson

Geo. M. Wilson
Executive Vice President
Billy Graham Evangelistic Association
1300 Harmon Place
Minneapolis MN 55403
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ADDENDUM

To assist the subcommittee in understanding Billy Graham Evangelistic Association's proposed amendments to S,1910, the text of the Bill is hereinafter repeated with lined-out words representing deletions from the present text and underlined words representing additions thereto.

A BILL

To amend sections 403(b)(2) and 403(b) of the Internal Revenue Code of 1954 with respect to computation of the exclusion allowance for ~~ministers and lay employees of a church~~: employees of religious organizations; to add a new section 403(b)(9) to clarify that a section 403(b) annuity contract includes an annuity contract of a ~~church, including a church pension board~~; religious organization; to conform section 403(c) with recent amendments to section 402(a)(1); to amend section 415(c)(4) to extend the special elections for section 403(b) annuity contracts to employees of religious organizations, including churches or conventions or associations of churches and their agencies; to add a new section 415(c)(8) to permit a *de minimis* contribution amount in lieu of such elections; and to make a clarifying amendment to section 415(c) by adding a new paragraph (9) and conforming amendments to sections 415(d)(1), 415(d)(2), and 403(b)(2)(B).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 403(b)(2)(B) of the Internal Revenue Code of 1954 is amended to read as follows:

"(B) ELECTION TO HAVE ALLOWANCE DETERMINED UNDER

SECTION 415 RULES.—In the case of an employee who makes an election under section 415(c)(4)(D) to have the provisions of section 415(c)(4)(C) (relating to special rule for section 403(b) contracts purchased by educational institutions, hospitals, home health service agencies, and religious organizations, including churches or conventions or associations of churches and organizations described in section 414(e)(3)(B)(ii) apply, the exclusion allowance for any such employee for the taxable year is the amount which could be contributed (under section 415 without regard to section 415(c)(8) by his employer under a plan described in section 403(a) if the annuity contract for the benefit of such employee were treated as a defined contribution plan maintained by the employer."

SEC. 2. Section 403(b)(2) of the Internal Revenue Code of 1954 is amended by adding the following subparagraph:

"(C) NUMBER OF YEARS OF SERVICE FOR ~~DULY-ORDAINED, COMMISSIONED, OR-LICENSED-MINISTERS-OR-LAY-EMPLOYEES.--~~ EMPLOYEES OF RELIGIOUS ORGANIZATIONS.--For purposes of this subsection, all years of service by a ~~duly ordained, commissioned, or licensed minister~~ an employee of a ~~church, or by a lay person as an~~ religious organization, including any employee of a church or a convention or association of churches or an organization described in section 414(e)(3)(B)(ii) of such church (or convention or association of churches) shall be considered as years of service for 1 employer, and all amounts contributed for annuity contracts by each such ~~church (or convention or association of churches) or such organization~~, religious organization, during such years for such ~~minister or lay person~~, employee, shall be considered to have been contributed by 1 employer. For purposes of the preceding sentence, the term 'church (or convention or association of churches)' shall have the same meaning as it does for purposes of section 414(e).".

SEC.3. Section 403(b)(3) of the Internal Revenue Code of 1954 is amended by adding at the end the following sentence: "Notwithstanding the preceding sentences, the includible compensation of an employee described in paragraph (2)(C) is not less than twice the nonfarm income poverty guideline of a family unit of 4 who resides in the contiguous United States for the prior taxable year in accordance with regulations prescribed by the Secretary. Such regulations shall provide for procedures to establish and revise the nonfarm income poverty guideline which are similar to the procedures used by the Office of Management and Budget for programs in which the poverty line is a criterion of eligibility.".

SEC. 4. Section 403(b) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(9) CERTAIN ANNUITY CONTRACTS.--For purposes of this subsection, the term 'annuity contract' includes an annuity contract provided by a religious organization, including a church or a convention or association of churches, <u>and</u> including an organization described in 414(e)(3)(A).".

SEC. 5. The last sentence of section 403(c) (relating to taxability of beneficiary under nonqualified annuities or under annuities purchased by exempt organizations is amended by striking out "or made available".

SEC. 6. Section 415(c)(4) of the Internal Revenue Code of 1954 is amended to read as follows:

"(4) SPECIAL ELECTION FOR SECTION 403(b) CONTRACTS PURCHASED BY EDUCATIONAL ORGANIZATIONS, HOSPITALS, HOME HEALTH SERVICE AGENCIES, AND <u>RELIGIOUS ORGANIZATIONS, INCLUDING</u> CHURCHES OR CONVENTIONS OR ASSOCIATIONS OF CHURCHES AND THEIR AGENCIES.--

"(A) In the case of amounts contributed for an annuity contract described in section 403(b) for the year in which occurs a participant's separation from the service with an educational organization, a hospital, a home health service agency, or a <u>religious organization, including a</u> church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the amount of the exclusion allowance which would be determined under section 403(b)(2) (without regard to this section) for the participant's taxable year in which such separation occurs if the participant's years of service were computed only by taking into account his service for the employer, as determined for purposes of section 403(b)(2), during the period of years (not exceeding 10) ending on the date of such separation.

"(B) In the case of amounts contributed for an annuity contract described in section 403(b) for any year in the case of a participatnt who is an employee of an educational organization, a hospital, a home health service agency, or a <u>religious organization, including</u> a church or convention or association of churches or any organization described in section 414(e)(3)(B)(ii), at the election of the participant there is substituted for the amount specified in paragraph (1)(B) the least of--

"(i) 25 percent of the participant's includible compensation (as defined in section 403(b)(3) plus $4,000,

"(ii) the amount of exclusion allowance determined for the year under section 403(b)(2), or

"(iii) $15,000.

"(C) In the case of amounts contributed for an annuity contract described in section 403(b) for any year for a participant who is an employee of an educational organization, a hospital, a home health service agency, or a <u>religious organization, includ-ing</u> a church or convention or association of churches or any organization described in 414(e)(3)(B)(ii), at the election of the participant the provisions of section 403(b)(2)(A) shall not apply.

"(D)(i) The provisions of this paragraph apply only if the participant elects its application at the time and in the manner provided under regulations prescribed by the Secretary. Not more than one election may be made under subparagraph (A) by any participant. A participant who elects to have the provisions of subparagraph (A), (B), or (C) of this paragraph apply to him may not elect to have any other subparagraph of this paragraph apply to him. Any election made under this paragraph is irrevocable.

"(ii) For purposes of this paragraph the term 'educational organization' means an educational organization described in section 170(b)(1)(A)(ii).

"(iii) For purposes of this paragraph the term 'home health service agency' means an organization described in subsection 501(c)(3) which is exempt from tax under section 501(a) and which has been determined by the Secretary of Health and Human Services to be a home health agency (as defined in section 1861(o) of the Social Security Act).

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"(8) CERTAIN TOTAL ANNUAL CONTRIBUTIONS AND ADDITIONS NOT IN EXCESS OF $10,000.--In the case of a participant who is an employee of a hospital, an organization described in paragraph (4)(D), or an organization described in section 414(e)(3)(B)(ii), notwithstanding any other provision of this subsection, contributions and other additions for an annuity contract described in section 403(b) with respect to such participant, when expressed as an annual addition (within the meaning of subsection (c)(2) to such participant's account, shall not be deemed to exceed the limitation of subsection (c)(1) if such annual addition is not in excess of $10,000.00.".

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"(D) the $10,000 amount in subsection (c)(8),

for increases in the cost of living in accordance with regulations prescribed by the Secretary. Such regulations shall provide for adjustment procedures which are similar to the procedures used to adjust primary insurance amounts under section 215(i)(2)(A) of the Social Security Act.".

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G. M. W.

STATEMENT OF

ROY L. WILLIAMS

GENERAL PRESIDENT

INTERNATIONAL BROTHERHOOD OF TEAMSTERS

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to present the Subcommittee with the views of the International Brotherhood of Teamsters (IBT) on the crucial role which private multiemployer pension plans <u>can</u> <u>and</u> <u>should</u> be allowed to play in the revitalization of the residential construction industry.

We in the Teamsters have been among the millions in our great nation who have previously benefitted from the fruits of a growing economy. However, as we view the nation we love now caught in the mire of a stagnant economy, we feel the need to help find solutions. One approach we have considered would help revitalize the nation's troubled construction industry and, we believe, at the same time create new jobs for thousands of currently unemployed union workers -- among them many Teamsters.

That approach would involve the use of union pension fund monies to provide secured home mortgage loans to qualified applicants.

This plan was not devised precipitously, nor without regard for the needs and security of millions of Teamster members. Rather it is a thoughtful and deliberate attempt to alleviate one of the nation's ills and, to be candid, to serve the best interests of our pension funds.

We believe that a resurgent housing construction industry is essential if our economy is to get back on a sound footing. If union pension funds were properly encouraged to make home loans at below the currently prevailing interest rates, while at the same time fully protecting the health and fiduciary responsibilities of the funds, we believe a rapid comeback of the housing industry would be possible.

There are some 230 multiemployer pension plans affiliated with the IBT. The assets are managed by independent fiduciaries who must undertake their investment responsibilities for the sole benefit of plan participants and beneficiaries.

It is our union's judgment that no contradiction need exist with an investment policy in which plan fiduciaries properly address the best long-term economic interests of the plans and their participants and, at the same time, inject an infusion of substantial capital into the residential construction market at rates which are within the means of the average worker. Indeed, our multiemployer plans require a healthy contribution base, and that is only possible with a strong economy.

Last month I conveyed to President Reagan the concerns and views of the IBT in this area. Our ideas were intended to serve as a catalyst for a vigorous and constructive reexamination of federal policies in the ERISA investment area. I applaud the initiative which this Subcommittee has taken in actively soliciting the views of major policymakers in the pension field and I hope that these hearings mark the start of responsible and meaningful cooperation between the government and the private sector in dealing with the present crisis.

Let me now briefly summarize the interrelationship between the housing crisis and the economic welfare of many large multiemployer plans.

The housing industry in the United States is at its lowest point since 1946. Statistics indicate that sales of new homes have dropped approximately sixty percent below the levels achieved in 1977-1978. Total public and private construction starts for 1981 were down 16% from the 1.31 million level reached in 1980. The 1980 figure itself represents a 25% decline below the 1979 level, which in turn fell 14% below the 2.036 million starts in 1978.

This situation, when translated into lost job opportunities, is tragic indeed. Unemployment in construction during March 1982 involved 928,000 workers reflecting a 17.9% unemployment rate, nearly double the unemployment rate for the entire economy.

The trauma of the construction industry, as you can imagine, has had a widespread ripple effect which has adversely affected many of the industries covered by the IBT pension plans.

While many of the painful human consequences which these figures represent are obvious -- including the gnawing frustration felt by young wage-earners who are now simply incapable of fulfilling the American dream of home ownership - there is a more subtle but no less serious consequence: the direct impact of these conditions upon the present and future retirees of this country's multiemployer pension plans. Depressed construction starts and the concomitant increase in unemployment levels have caused a constriction in the true lifeblood of multiemployer pension plans - the contributions needed to fund past, present and future benefits.

In our worsening economy, IBT pension plans, as well as others, have felt the effects of a collapsed housing construction market. Many industries covered under IBT plans, such as hauling, storage and, in some cases, manufacturing, have been hit hard.

Many people fail to recognize the simple fact that multiemployer pension plans can continue to provide full benefits to current retirees and future retirees only if employer contribution base units are maintained at actuarially adequate levels. Each new dollar that is contributed to the typical multiemployer pension plan is applied both to the funding of current benefits earned by the worker on whose behalf the contribution is being made, as well as past service credits granted for prior employment in the industry.

Fiduciaries of the IBT pension plans feel strongly an obligation to invest plan assets in a fashion which will produce the greatest rate of return for the risk level selected. But fiduciaries also know that investment strategies that do not properly consider the liquidity needs of the plans, including the maintenance of critical levels of continuing contributions, will not be effective. A high rate of return on current plan assets is not sufficient for the long-term fiscal soundness of a plan if contribution levels continue to decline.

I might point out here that while corporate stocks and bonds are considered highly fiduciarily responsible investments for multi-employer plans, many plans — including some of our own large plans — found themselves with very, very low rates of return in 1981 because of heavy investments in a declining stock market.

The IBT maintains that consideration of the job creation potential arising from investment decisions is a fully legitimate and, indeed, required factor to apply in the master strategy of investment decision-making.

Statistics indicate that an infusion of capital into the residential construction market may have a substantial direct impact on the contribution base of IBT pension plans.

A study undertaken by the National Association of Home Builders indicates that the employment impact of 1,000 new single family units involves the creation of 627 man years of employment (at 1,800 hours per man year) in the on-site and off-site construction industry. At the same time, an additional 897 man years of employment (involving wages of over $13,000,000) would be created in other industries such as transportation, manufacturing and wholesale trade, together with 235 man years attributable to land development.

It is the strong feeling of the IBT that ERISA fiduciary rules should permit an investment manager to consider both the rate of return established under a mortgage loan, as well as the projected level of additional contributions created through the mortgage loan, in evaluating the economic consequences of a mortgage investment.

If the rate of return of a mortgage loan itself is not comparable to the rate of return which an investment with a similar risk would generate, the fiduciary should be allowed to reasonably project the value of additional contributions resulting from the investment.

If the net benefit to the plan of the future stream of supplemental contributions plus the rate of return established under the proposed loan results in a figure comparable to other investments with similar risk levels, ERISA policy should not artificially constrain the fiduciary's ability to avail the plan of the mortgage investment opportunity. Under this approach, a sufficiently large projected supplement to the plan's contribution base would permit the making of mortgage loans with an interest level as low as 10%.

We envision a program under which IBT pension plans could make a portion of their assets available for new residential mortgage loans at rates which exceed by several points the actuarial earnings assumption utilized by the plans but which fall significantly below market rates. In the event market rates are reduced in future years so that money becomes available to the average worker through traditional sources, this program automatically could be phased out.

As we have pointed out, investment return is not the sole cornerstone in the foundation of a secure pension fund. Jobs are — jobs that build the participant base of a fund, that cause contributions to be made to a fund on a worker's behalf, that bring in the income to invest. Without employers in business, without people working and earning, there would be no pension funds.

Today it is not the absence of a sufficient pool of funds for lending that has called a virtual halt to the first-time homebuyer's ability to buy that starter house, to new residential construction, and to the movement of existing housing at all but the highest brackets.

Rather it is that, especially given the great jump in the prices of housing in the past five years, the middle-income earner who buys most of the homes in this country simply cannot afford the high interest rates, excessive down payments, and the exorbitant monthly payments.

We in labor learned long ago that our fortunes are tied closely to those of our nation's economy. When conditions are bad for business and industry, they are bad for our members. Using labor's funds to support labor's goals and workers' hopes seems to us to be a sound and responsible action.

The selection of appropriate interest rates would require much sophisticated analysis. It is our hope that federal policymakers will assist in the implementation of this approach. Indeed, the resources of the Department of Labor could provide much-needed assistance in the development of a suitable methodology for the quantification of the present value of anticipated contribution units. Such assistance would be enormously beneficial for plan fiduciaries and for the plans themselves.

We are concerned, however, that the present views of the Department of Labor may actually chill rather than encourage an investment program of this nature. It is true that the Department has recently taken some very constructive steps in the removal of certain impediments to mortgage investment opportunities, such as the recent release of Prohibited Transaction Exemption 82-87. The Department's position on "below market" loans has been less clear.

On January 19, 1981, the Department issued a letter to the National Coordinating Committee for Multiemployer Plans which indicated, in the context of loans to plan participants, that a "reasonable rate of interest" for purposes of Section 408(b)(1) of ERISA may be less than "market" if the loan transaction involved other characteristics which distinguished it from a routine loan, such as a more favorable term, security, level of borrower equity or discount. The Department has not, to my knowledge, indentified the creation of additional contribution assets as a factor which would justify a below market interest rate.

For the reasons stated above, the IBT encourages federal support of this proposal and calls for the rapid development of reasonable and constructive investment guidelines which recognize the realities of multiemployer plans.

We feel that the present problems of the construction industry and the ripple effect which has plagued thousands of our own members merit no less than the full and imaginative cooperation of all interested parties, including the multiemployer plan community.

Fiduciaries of the IBT pension plans have indicated they would be anxious to enlist in the cause of developing a responsible investment program which addresses these concerns of national interest and the interests of plan participants. We therefore respectfully request that the federal government encourage rather than restrict our efforts in this direction and join us in a cooperative spirit to help alleviate this national economic crisis.

Mr. Chairman, attached to this testimony is an editorial from the Chicago Tribune, Friday, May 14, 1982, related to the subject of this hearing. I request that it be made part of the record at the conclusion of my remarks.

Again, Mr. Chairman, I wish to express my appreciation for this opportunity to present our views.

Chicago Tribune

FOUNDED June 10, 1847

26 Section 1 Friday, May 14, 1982

Unions vs. the recession

One good thing about a recession is that it gives rise to a lot of ideas for combating recessions. Among the best are the recently announced plans by major unions to use their pension funds as stimulants for the housing industry and the many jobs that depend on it.

The Chicago District Council of Carpenters disclosed last week that it was pumping $10 million from its pension fund into low-interest loans for buyers of new homes in Cook, DuPage and Lake counties. Conventional loans are now running at about 17 percent interest; this money will make available mortgages at 11.9 percent.

Financial institutions that get this money will provide up to $500,000 each to union contractors, who will have six months to build the homes and find buyers for them at the 11.9 per cent rate. It is stipulated that the houses or apartments will be no higher than 3½ stories and will be built by union labor.

The 11.9 percent is not only less than buyers would generally have to pay elsewhere; it is also less than the union could earn from certain other kinds of investments. To this extent the union is making a sacrifice. The offsetting benefit is that many more of its 35,000 members in the three-county area will have jobs. George Vest Jr., president of the carpenters' district council, estimates that the low-interest loans will create at least 66,000 man-hours of employment.

Other hard-hit trades involved in home building—roofers, painters, electricians, sheet metal workers, cement finishers—can expect similar benefits, and other unions undoubtedly will follow the carpenters' lead in using pension funds to create jobs.

The biggest step in this direction is being taken by the giant Teamsters union, which plans to make $18 billion in pension funds available to lending institutions for construction loans and home mortgages at 10 percent. That should bring about a massive resurgence in the home-building industry, which has been pinned to the floor by heavy interest rates. And when home building picks up, so do employment rates; no other industry has so direct an effect on so many different trades.

In outlining the plan in a letter to President Reagan, Teamster president Roy L. Williams called for his support in making whatever changes it may require in federal pension regulations. Mr. Reagan certainly should not object to having labor's powerful financial muscle allied with him (and everyone else) against unemployment and high interest rates.

This direct involvement of labor's resources in strengthening the economy is a healthy evolutionary trend that should stay with us long after recession has become a memory.

NATIONAL ASSOCIATION OF
EVANGELICALS
OFFICE OF PUBLIC AFFAIRS/1430 K STREET NW/WASHINGTON DC 20005/(202) 628-7911

June 2, 1982

Mr. Robert Lighthazer, Chief Counsel
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

RE: WRITTEN STATEMENT BY FOREST D. MONTGOMERY, COUNSEL, OF THE NATIONAL ASSOCIATION OF EVANGELICALS ON MAY 19, 1982 BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY OF THE COMMITTEE ON FINANCE

S. 1910 would make certain changes in the Internal Revenue Code relating to retirement arrangements under section 403(b), and to qualified plans for clergy and lay employees of churches, conventions or associations of churches, and organizations that are exempt from tax under section 501 and which are controlled by or associated with a church or convention or association of churches.

Unfortunately, current law does not literally cover certain other religious organizations, though the ministry they conduct and activities in which they are engaged are essentially similar to organizations covered under existing law. We refer to such "para-church" organizations as Campus Crusade, Youth for Christ, the Billy Graham Evangelistic Association, etc.

We respectfully urge the amending of current law to include these organizations. We assume this change would be noncontroversial and would be happy to assist in the drafting of suitable statutory language to effect the suggested change.

NATIONAL
Bank of Alaska
Corporate Headquarters P O Box 600 • Anchorage Alaska 99510 • (907) 276 1132

June 2, 1982

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Finance Subcommittee on Savings, Pensions, and Investment Policy, Hearing On Mortgage Investments By Pension Funds, May 19, 1982

Dear Mr. Lighthizer:

National Bank of Alaska appreciates the request to present its views to the Subcommittee on the important subject of pension fund investments in mortgages.

National Bank of Alaska (NBA) is the largest bank exercising trust powers in the State of Alaska, holding approximately $400 million in pension assets on behalf of some 250 employee benefit plans. For many years, NBA has invested a significant portion of these pension assets in first mortgages on residential and commercial real estate in Alaska. These investments have proved to be a highly safe method of investing pension assets to meet the funding obligations of the plans, while at the same time insuring that a significant part of the pension assets of Alaska employees are invested in Alaska for their continued benefit -- thereby stimulating further employment and home ownership at reasonable mortgage rates for these Alaska employees.

Unfortunately, the prohibited transaction provisions of the Employee Retirement Insurance Security Act of 1974 (ERISA) have substantially raised the costs of such investments, and through escalating its risk associated with the transaction have made us reluctant to make any further real estate mortgage investments for employee benefit plans. We believe our experiences with ERISA have been shared by the other financial institutions in Alaska and elsewhere. The consequence is that ERISA as a practical matter unfairly and unreasonably imposes restrictions on mortgage investments which are not present with respect to securities purchased through a broker. Thus, ERISA encourages banks simply to invest in corporate stocks and bonds, even though the long-term performance of these

Mr. Robert E. Lighthizer
June 2, 1982
Page Two

investments has been worse generally than the return on sound first mortgages and does absolutely nothing directly for the Alaska employees. This further adds to the depressed state of the real estate construction industry in Alaska.

As a first and much needed step to stimulate the availability of mortgage funds, the wholly excessive restrictions of the prohibited transactions provisions of ERISA Section 406 must be removed. We wholeheartedly support the provisions of S.1541 which would amend Section 406(a) (I) of ERISA to allow all transactions (not just mortgage loans) between the plan and "parties in interest", provided such transactions do not inappropriately benefit the party in interest at the expense of the plan. Not only would this change greatly ease paperwork requirements by eliminating the need for bureaucratic review of exemption requests, it will remove the draconian penalties of ERISA for transactions later found to be technical violations that all would concede have not resulted in loss or even risk of loss to the plans.

We urge the Subcommittee to take prompt action to abolish the unnecessary restrictions which ERISA imposes upon pension fund mortgage investments.

Sincerely,

Edward B. Rasmuson
President

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