TESTIMONY OF
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THE ERISA INDUSTRY COMMITTEE

BEFORE THE COMMITTEE ON FINANCE
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ON FUNDING OF DEFINED BENEFITPENSION PLANS

Mr. Chairman, members of the Committee, thank you for the opportunity to present the views of The ERISA Industry Committee on the funding of defined benefit pension plans. I am Christopher O'Flinn, Vice President, Corporate Human Resources, AT&T Corporation, and Chairman of The ERISA Industry Committee (ERIC), on whose behalf I am speaking today.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

ERIC has a unique interest in funding rules for defined benefit plans because about 95% of the ERIC membership sponsor defined benefit pension plans. They also provide 401(k), health, and other benefits.

Summary

In 2001 the U.S. Treasury ceased to issue the 30-year Treasury bond on which the funding of defined benefit plans is statutorily based. As a result, we are left with an artificial interest rate that fails to reflect any rational basis with which to regulate pension plan funding. The lack of a rational rule has created uncertainty that, among other effects, has caused the stock of sound companies to be undervalued by stock analysts concerned about their potential future funding obligations.

Prompt action to replace the defunct 30-year Treasury bond rate for purposes of regulating pension plans is critical to protect the retirement security of millions of American workers and to avoid undercutting the ability of many companies to fuel national economic recovery

ERIC urges the Committee to replace the 30-year Treasury rate with a composite rate of high-quality, long-term corporate bond indices that would be selected through Treasury regulations. ERIC also proposes to

- Coordinate the new rate with related mortality assumptions;
- Phase in the new rate for lump sum calculations; and
- Reduce the frequency with which employers bounce in and out of the current liability funding and quarterly contribution requirements.

(see attached proposal and background materials)

A composite corporate bond rate is generally recognized as a reasonable proxy for annuity purchase rates, which corresponds to the rationale for choosing 30-year Treasury rates as a benchmark in 1987. The proposed composite rate is higher than today's 30-year Treasury rate. But this is appropriate because the current use of the Treasury rate overstates the minimum funding needed to assure retirement security for plan participants.

The overstatement of liabilities frequently is requiring the diversion of hundreds of millions of dollars in a single company. Overstating liabilities is forcing some employers to make economically rational decisions to freeze, modify, or abandon their defined benefit plans, thus adversely impacting retirement security. Use of the defunct 30-year Treasury rate also causes participants to elect lump sums in circumstances where they would be better protected by an annuity.

Other possible replacements for the 30-year Treasury rate do not provide the combination of simplicity, transparency, relevance, immunity from manipulation, and availability provided by a composite corporate bond rate.

Congress must be careful not to overreact to reports raising concerns about the current status of pension funding. Part of the problem is that current law mismeasures the severity of any problems. In addition, the combined impact of a dramatic drop in asset values combined with an increase in calculated liabilities due to low interest rates is unusual and is not a sound platform for major reshaping of pension funding requirements.

At the same time, Congress should recognize its ability and responsibility to improve the climate for defined benefit plans in the future. For example, Congress imposed ever-harsher deduction limits on voluntary contributions to pension plans during the 1980s and 1990s, a trend that the Grassley-Baucus pension reform measures enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) began to reverse. Had restrictive deduction limits not been imposed during recent decades, many plans would be better funded today despite the current economic slowdown.

Finally, the current financial status of the Pension Benefit Guaranty Corporation (PBGC) should be monitored by Congress, but does not require any action at this time. The PBGC's funded ratio still is stronger than it has been for most of its history, and the

corporation is abundantly able to pay promised benefits to participants in plans it trustees for the foreseeable future.

Overview of Funding Rules

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, ERISA and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan. These minimum required contributions are calculated using reasonable assumptions and are equal to the normal cost of the plan plus amounts necessary to amortize over specified periods unfunded past service liabilities, experience gains or losses, waived funding deficiencies, changes in actuarial assumptions, and certain other items. Most defined benefit plans are funded under these original ERISA rules, as modified over time.

A plan that is either significantly or persistently underfunded will be subject to an additional set of funding rules. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan, accelerating the pace of pension funding. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994, and are the focus of our discussion today.

The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is within a range of rates based upon the four-year weighted average of 30-year Treasury bonds. As amended in 1994, amendments, the permissible range is no lower than 90% of the 30-year bond average and no higher than 105% of the 30-year bond average. For 2002 and 2003 only, a plan may use a rate of up to 120% of the 30-year bond average. Congress enacted this short term-higher range last March (P.L. 107-147) in recognition of the fact that, as a result of the rise of budget surpluses followed by the decision of the Treasury to cease issuing 30-year bonds, the 30-year bond rate had dropped to levels that produced highly inaccurate and inflated calculations of pension liability.

The current liability rules come into play if, using these mandated assumptions, a plan is significantly or persistently underfunded -- that is, if plan assets are less than 80% of current liabilities or if a plan assets are less than 90% of current liabilities for two of the last three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

Current liability is also calculated to determine whether a plan sponsor will pay a $19 per participant flat rate premium tax to the Pension Benefit Guaranty Corporation, or whether the sponsor must, in addition, pay a variable rate premium tax based on the plan's unfunded vested benefit liability.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.

What happens if the 30-year Treasury rate is not promptly replaced?

If Congress fails to act, 2004 current liability calculations will be dictated by a maximum rate of 105% of the four-year weighted average of (defunct) 30-year Treasury bonds. Using the rates in effect on January 1, 2003, as a proxy, this would mean that plans would be forced to calculate their current liabilities with a maximum interest rate of 5.82% compared to 7.41% under the ERIC proposal. If this were to occur–

- Current liability calculations would increase by 15% or more.
- Many additional companies, including companies with plans that are in fact well-funded, would become subject to the special funding rules. Both they and those already subject to the rules would experience a spike in their contribution requirements. This will unnecessarily divert money that otherwise would have be spent to build new plant, buy equipment, pay for research and development, and support jobs.
- Plans that become subject to the current liability funding rules also must notify employees of their underfunded status (even if the plan is not underfunded using reasonable measures), and must pay variable rate premiums to the PBGC. Business operations of these plan sponsors also come under increased scrutiny by the PBGC.

There is no economic justification for these consequences. Thus, it is apparent that affected companies will find their support for defined benefit plans diminished. A strong financial incentive will be created to limit future liabilities. Where cash is in short supply, companies will have no option but to freeze their plans.

There is additional fall-out just from the uncertainty companies currently face. CEOs and CFOs need to know now whether they will be able to purchase new plant and equipment, to invest in research and development, and to accomplish other vital business objectives.

Consequences of the funding squeeze, caused in part by the continued reliance on the 30-year Treasury rate, already are occurring. A recent survey by Deloitte & Touche indicated that more than four out of ten defined benefit plan sponsors are either making or are considering making fundamental changes to their defined benefit plans. About a quarter of those making or considering changes either already have or are inclined to freeze benefits in the plan.

Action on a replacement rate is needed now. Analysts already are steering investors away from companies with a cloudy contribution forecast. Action by the end of the second quarter, after which planning for 2004 becomes critical, is vital. Delay means

damage to plans and their participants, damage to companies, and damage to companies' ability to fuel economic recovery.

Why should a composite corporate bond rate be selected as the replacement for 30-year Treasury rates?

The current liability funding rules are designed to shore up funding in a plan that would have a serious shortfall if it were to terminate and purchase annuities to provide benefit payments. Thus, as the GAO reported less than two weeks ago, "the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices and not be subject to manipulation." (GAO-03-313)

Insurance companies tend to invest in long-term corporate debt. Therefore, a composite corporate bond rate will track changes in annuity purchase rates.

ERIC'S composite rate is composed of high-quality, long-term corporate bond indices. High quality (generally the top two quality levels) provides a reasonable level of security for pension plan sponsors to defease their liabilities.

ERIC's composite rate indices also are comprised of bonds with average maturities of 25-30 years (implying durations of 10-12 years), which corresponds to the typical duration of pension plan liabilities.

When the 30-year Treasury bond rate was selected as a compromise basis for the new pension funding rules established in 1987, Treasury rates were closer to corporate bond rates than they are today. Moreover, mortality assumptions in use at the time were outdated, so having an interest rate that was overly conservative made sense.

The composite corporate bond rate in the ERIC proposal is based on indices that are published by major investment houses, based on disclosed methodology, and publicly available. The composite rate is based on information familiar to plan actuaries; it is simple for plans to implement; it is transparent, and it is strongly immune from manipulation.

What about mortality assumptions?

Under current law, Treasury is required periodically (and at least every five years) to review the mortality table required for current liability funding calculations and to update the table as appropriate to reflect the actual experience of pension plans (including permitting plan-specific adjustment factors such as employment classification, lifetime income, and other relevant demographic factors) and projected trends in such experience. An update in the required table is overdue.

ERIC recommends that the use of the RP 2000 Combined Mortality Table, produced by the Society of Actuaries based on a large study of pension plan experience, be required for funding and variable rate premium purposes at the time the composite rate becomes

effective. Use of the new table will have the effect of increasing current liability calculations for most plans, partially offsetting the effects of adopting the composite corporate bond replacement for the 30-year Treasury bond.

ERIC proposes no changes for mortality assumptions for lump-sum distributions, since they already are being updated under a separate provision of law.

What about lump sum distributions?

It is important that the lump sum discount rate reflect the plan's discount rate. Any disconnect between the lump sum rate and the funding rate will cause plan distributions to either exceed or fall short of estimates used in the plan.

Today's low rate also presents participants deciding between a lump sum distribution and an annuity a choice that is overwhelmingly weighted toward the lump sum. This is in direct contravention of long-established policy that the choice should be economically neutral. As use of lump sums increases, fewer joint and survivor benefits are selected, adversely affecting long-term participant security. In addition, the plan's funding level is adversely impacted.

- Lump sums paid under a defunct Treasury rate are, in fact, windfall benefits that have damaging side effects for long term retirement policy and for the company sponsoring the plan.

- Elderly widows and widowers and others who outlive their assets and have no retirement income stream other than Social Security constitute one of the most vulnerable pockets of poverty today. The current lump sum structure will increase the number of spouses and others left adrift in the future if that lump sum is dissipated.

- Actuarial estimates indicate that a lump sum benefit under the current inappropriate discount rate increases the cost of the benefit to the plan by 17-40%. Many plans cannot absorb these costs and have been freezing or curtailing benefits. Thus, while some current retirees receive a windfall based on an anomaly in the government debt structure, future retirees will receive reduced benefits overall.

- Finally, Internal Revenue Code section 417(e) not only dictates the minimum lump sum rate, but also the rate that regulations encourage companies to use as the interest credit rate in cash balance plans. Thus, maintaining an artificially low lump sum rate for some current retirees means that millions of participants in cash balance plans are losing benefits compared to what they would be earning if the rate were rational.

ERIC proposes that the new interest rate be phased in over a three-year period. The three-year phase-in will align the two rates over time while ensuring that the shift from a

defunct 30-year Treasury rate to the composite rate will not have abrupt effects on participants at or very near retirement.

Historically, the lump sum discount rates have averaged about 7%. Today's mandated rate is 4.92%. Under the ERIC proposal, if current rates remained in effect without change, this would gradually increase to a level of about 6.23% over a three-year period – still short of historical averages. The phase-in is designed to roughly approximate normal fluctuations of interest rates in a given year. Thus the changes would be within the margins of change that already occur on a year-to-year basis. In addition, in the second and third years, lump sums of many employees would increase from estimates made today because additional years of age and service would be included in the calculation.

What's wrong with selecting another government rate or a yield curve instead of a composite corporate bond rate?

Any other government rate is going to suffer from the same weaknesses as the 30-year Treasury rate – any relation to annuity purchase prices will be tangential or accidental. Indeed, as the GAO noted (p. 5), "Treasury rates' proximity to group annuity purchase rates might be adversely affected if investors' demand for risk-free securities increases, causing Treasury rates to decline relative to other long-term rates."

Government rates reflect the government's cost of borrowing, not the rate of return on an insurance company's portfolio. Thus they inherently lack relevancy for the purpose at hand.

Corporate bond yield curves might enable a plan to more closely approximate its group annuity purchase rate. However, the extra precision involved is outweighed by several drawbacks. For example:

- There has been little public discussion of a yield curve, a complicated proposal. Adequate consideration of a yield curve between now and July, when a replacement for 30-year Treasuries must be in place, could not occur. It would need substantially more time for debate and analysis. There are a number of highly technical issues involved in switching to a yield curve that have not been explored or addressed.

- Companies already unsure of their cash flow situation will be thrown into even greater confusion, to the detriment of their ability to participate productively in the economy.

- Since it would make no sense to average a yield curve over four years, an annual rate likely would be used. Unless some other "smoothing" mechanism is devised, this will substantially increase pension funding volatility.

- In addition to decreasing pension funding volatility, the current averaging mechanism gives plan sponsors the ability to estimate funding obligations well in

advance of the year for which they are due. Basing contributions on an unknowable "spot rate" decreases the ability of sponsors to plan capital commitments.

- Introducing volatile, unpredictable cash flow requirements is a significant burden on plan sponsors. As a result, maintaining a defined benefit plan will become less and less economically feasible for more companies. It would be impossible for Congress to overestimate the negative impact of turning at this point in time to a pension funding system that increased the volatility and unpredictability of required pension contributions.

- A yield curve would likely increase required contributions in plans with large numbers of retirees. This could cause very severe economic hardship for those companies.

- A yield curve, combined with the current law deduction limits, would result in less ability for a plan sponsor to fund the plan while participants are younger because it would delay the ability to deduct maximum contributions to periods when the workforce is more mature and declining, and when the company may face new or different economic pressures. It would, in effect, negate some of the good of the Grassley-Baucus amendment in EGTRRA, which phases out deduction limits that had a similar effect of delaying funding over the past decades.

- If a "precise" interest rate such as a yield curve is mandated, a precise mortality assumption also must be considered. Otherwise, industrial plans whose participants have shorter life spans will be required to excessively fund their pension plan. However, such use of such an assumption is likely to be controversial and will require additional discussion, as it will have different impacts on different plans.

- It is unclear how a yield curve would be applied for purposes of lump sum payments, raising a host of additional issues.

- A yield curve is likely to be far less transparent than a composite index; it may be more vulnerable to manipulation; it will be more difficult for the government to police, and it certainly will be more complicated.

A yield curve may impose these drawbacks on the defined benefit system for no real long-term gain over the more simple approach of a composite corporate bond rate.

What can Congress do to help?

Besides prompt enactment of a replacement for 30-year Treasury bond rates, Congress has important opportunities to improve the climate for defined benefit plans.

- Congress can provide for additional stability in companies' funding requirements by enacting ERIC's proposals regarding the volatility and quarterly contribution rules.
- Congress can also provide for increased deductibility for voluntary contributions made in excess of the current required amounts.

Should Congress be concerned about allegations that the PBGC is in trouble?

The short answer is, "No." Congress should monitor the financial status of the PBGC, but should recognize that the PBGC's funded status is better than it has been for most of its existence. It is in fact not in trouble and appears readily able to weather the current economic slowdown (see chart).

Should long-term problems emerge, there will be ample time and resources to address PBGC issues, unless short-sighted measures drive PBGC's premium payors away from the defined benefit system.

The loss of the PBGC's surplus should not be a surprise in the current economic circumstances and is, in itself, not a cause for alarm. Indeed, given the requirement in ERISA sec. 4002 that the PBGC "maintain premiums established by the corporation…at the lowest level consistent with carrying out its obligations under this title," maintaining a surplus might be in violation of the corporation's charter.

The economic health of the PBGC is determined not by whether it has a surplus or deficit at any point in time but by its ability to pay benefits to participants of plans it trustees. The PBGC has sufficient assets to pay benefits for the foreseeable future. In fact, the PBGC has operated successfully in a deficit situation for most of its history. (see chart)

The real security of the PBGC lies not in imposing new rules that force cash-strapped companies to choose between survival and putting more money into their pension plans. It lies in fostering a vibrant system with lots of companies maintaining defined benefit plans on which they pay premium taxes to the PBGC.

We appreciate the opportunity to appear before the Committee and will be pleased to respond to questions and engage in further discussions either at or after the hearing.