American Benefits Council

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on behalf of the
American Benefits Council

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Chairman Grassley, Ranking Member Baucus, I thank you for the opportunity to appear before you today on this critically important topic. I am Henry Eickelberg, Staff Vice President for Benefit Programs for the General Dynamics Corporation. General Dynamics is a major defense and aerospace company employing over 48,000 people within the United States.

I am appearing today on behalf of the American Benefits Council, where General Dynamics serves on the board of directors. The American Benefits Council (Council) is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

Like you, Mr. Chairman, the Council and its member companies are very concerned and troubled by the health of the voluntary, employer-sponsored defined benefit pension system. The largest problem for employer-sponsored defined benefit plans is the required use of an obsolete interest rate for pension funding, pension premium and lump sum distribution calculations. Use of this obsolete benchmark -- the rate on 30-year Treasury bonds -- artificially inflates the plan's liabilities and required contributions, threatening employers' ability to continue their commitment to defined benefit programs for their employees. The effects of this interest rate anomaly are exacerbated by the current economic and stock market downturn, which has dramatically reduced plan asset levels, wiping out five years of asset gains in many cases. Employer sponsors of defined benefit plans also confront plan funding rules that aggravate the negative effects of economic slumps without allowing the development of financial cushions in good times, continued resistance by some to hybrid pension plans, and the prospect of counter-productive changes in pension accounting rules.

Fortunately, Congress can address many of these issues in a positive manner that will enable employers to provide financially sound pension programs. Our testimony details the current threats and opportunities below. After providing some background on the defined benefit system and the current state of pension funding, we discuss the need for pension funding reform and offer our views on the financial position of the PBGC. We then offer our recommendations for replacement of the 30-year Treasury bond, discuss the need to make certain 2001 pension reforms permanent and urge enactment of certain defined benefit reforms previously put forward by Chairman Grassley and Senator Baucus. We close with discussion of the recent regulatory efforts regarding hybrid plans and the potential threat posed by an emerging re-evaluation of pension accounting principles.

The Council commends the Committee for examining these issues, and we look forward to working with all Committee members in the weeks and months ahead to ensure that defined benefit plans remain a viable retirement plan design for employers.

Background on Defined Benefit Plans

Mr. Chairman, today's examination of our private-sector defined benefit pension system is urgently needed. While this system helps millions of Americans achieve retirement income security, it is a system in which fewer and fewer employers participate. The total number of defined benefit plans has decreased from a high of 170,000 in 1985 to 56,405 in 1998 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today.[1] There has been a corresponding decline in the percentage of American workers with a defined benefit plan as their primary retirement plan from 38% in 1980 to 21% in 1997. Looking at the decline in defined benefit plans over just the past several years makes this unfortunate downward trend all the more stark. The Pension Benefit Guaranty Corporation (PBGC) reports that it insured 39,882 defined benefit plans in 1999 but only about 33,000 plans in 2002. This is a decrease of over six thousand defined benefit plans in just three years. These numbers reflect the unfortunate reality that today's environment is so challenging that more and more employers are concluding that they must freeze or terminate their pension programs.

These numbers are particularly sobering because defined benefit plans offer a number of features that are effective in meeting employee needs – benefits are funded by the employer (and do not typically depend upon employees making their own contributions to the plan), employers bear the investment risk in ensuring that earned benefits are paid, benefits are guaranteed by the federal government through the PBGC, and benefits are offered in the form of a life annuity assuring that participants and their spouses will not outlive this benefit. The stock market conditions of recent years (and the corresponding decline in many individuals' 401(k) balances) have once again demonstrated to many the important role that defined benefit plans can play in an overall retirement strategy.

[1] The decline in sponsorship of defined benefit plans is in stark contrast to the increase in sponsorship of defined contribution plans, such as 401(k)s. According to the same official Department of Labor statistics, the number of defined contribution plans has increased from 462,000 in 1985 to 661,000 in 1997.

So, with these advantages for employees, a logical question is what has led to the decline of the defined benefit system? We see several factors that have played a role. First, we see a less than friendly statutory and regulatory environment for defined benefit plans and the companies that sponsor them. Throughout the 1980's and early 1990's, frequent changes were made to the statutes and regulations governing defined benefit pensions, often in the name of promoting pension "fairness." The primary driver behind these changes was a desire to eliminate potential abuses attributed to small employer pension plans. And yet, these rules were applied to across the board to employers of every size. The result was that defined benefit pension plans became increasingly expensive and complicated to administer. Additionally, plan design flexibility, which is so important to large employers, was impaired. During this same period Congress repeatedly reduced the benefits that could be earned and paid from defined benefit plans in the name of increasing federal tax revenues, thus significantly reducing the utility of these voluntary plans to senior management and other key decision-makers.

The current tax laws also saddles defined benefit plan sponsors with significant – and often unpredictable and untimely – financial commitments. Many companies have found the cost of maintaining a defined benefit plan more difficult in light of intense business competition from domestic and international competitors, many of whom do not offer defined benefit plans to their employees and so do not have the corresponding pension expense. In addition, employees have not tended to place great value on defined benefit pension benefits offered by employers, preferring "shorter-horizon" and more visible benefits such as 401(k) and other defined contribution plans, stock option or stock purchase programs, health insurance and cafeteria plans. So ironically, while defined benefit plans have been complicated for employers to administer and expensive for them to maintain, they have not resulted in a significant increase in employee satisfaction, which is one of the core reasons for an employer to offer a benefit program in the first place.[2]

The State of Defined Benefit Pension Plan Funding

Mr. Chairman, we are all aware that defined benefit plan funding is a serious concern today. For example, a January 2003 report from a national consulting firm found that a the pension benefit obligation funded ratio – the ratio of market value of assets to pension benefit obligations – is near its lowest point in 13 years.[3] At General Dynamics nearly every one of our 48,000 U.S. employees is covered by a defined benefit pension plan. While recent market conditions have eroded our pension plans' funded levels, we anticipate that in one of our major pension plans no contribution is needed and in our other major pension plan any short-term cash contributions will be *de minimis* to our overall financial performance.

It is important, I believe, to state an otherwise obvious fact. Over the short-term, a pension plan's funding level can fluctuate widely. Thus, looking at a pension plan's funding level at a specific point in time is a very misleading indicator of the pension plan's ultimate ability to pay out participant benefits (whether accrued or anticipatory). In such an analysis, the only relevant factor is and will always be the underlying financial strength of the employer sponsor. Simply put, pension plans do not go broke; employers do. An extremely poorly funded pension plan in the hands of a capable and profitable company sponsor, by law, cannot become the financial responsibility of the PBGC. The employer sponsor

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[2] Employee preference for account-based and more portable benefits has been a prime factor in the development of hybrid defined benefit plans, which are discussed below.

[3] *Capital Market Update*, Towers Perrin, January 2003.

must manage any pension liability just as it manages any other business liability. Thus, it is the inability of the employer sponsor to continue to make cash contributions to an existing pension plan (often as a result of financial problems in its core business) that is the direct and proximate cause of any negative financial ramifications employees and retirees experience flowing from a PBGC distressed termination.

To put it another way, it is not the pension plan that can't pay its bills, it is the insolvent employer sponsor. Corporations, such as General Dynamics, routinely enter into long-term business contracts, often creating as part of these contracts, liabilities far in excess of those created by a pension plan. Corporations must manage these liabilities to survive. But, the principal difference between the financial obligations assumed by a corporation under a business contract and those it would assume under a defined benefit plan is the much greater clarity and predictability in a business contract, of the employer's ultimate financial obligations, and particularly, any cash-flow requirements. In the opinion of the Council, until Congress is prepared to adjust federal law to provide rational and flexible cash-flow requirements in funding pension plans, employer sponsors will continue to remove them from their benefit programs. The predictability and flexibility of the cash-flow requirements is one of the great attributes driving the explosion of 401(k) and other defined contribution plans. The same attribute is needed in the defined benefit pension area.

The Council believes that the swing from the abundant funding levels of the 1990s to the present state of increasing deficits for many plans is due in large measure to the counterproductive pension funding rules adopted by Congress.

Over the nearly 30 years since the enactment of the Employee Retirement Income Security Act (ERISA), the Congress has alternated between strengthening the pension plan system and limiting the revenue loss from tax-deductible pension contributions. Beginning in 1986, Congress limited the ability of companies to make nondeductible contributions and lowered the maximum deductible contribution. In 1997 and after, some relief was provided, but the overall result is that our laws and regulations strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level. By 1995, only 18 percent of plans had a funded ratio of assets over accrued liabilities of 150 percent or more as compared with 45 percent in 1990.[5]

The result has been that companies sponsoring defined benefit plans have experienced a dramatic shift in funding. During much of the 1990s, the popular press regularly reported on the pension funding holidays experienced by a number of large employers as if these "holidays" presented employers with a financial windfall at the expense of employees. Yet what was never reported was the simply fact that these contribution holidays were most often not a matter of employer choice; rather the internal revenue code imposed heavy tax penalties on employers that made additional contributions during a contribution holiday. Many suspected that plans experiencing these policy-induced funding holidays would eventually confront a harsh reality when funding levels declined. That has proven to be very true. As one observer presciently noted in 1996:

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[5] Table 11.2, EBRI Databook on Employee Benefits, 1997, 4th Edition, The Employee Benefits Research Institute, Washington, D.C.

> These contribution holidays created by OBRA 87 ultimately may prove to be a narcotic that will signal the death knell for some defined benefit plans. It is one thing for a company to see its annual contributions to its pension program rising by a couple of percentage points from a starting contribution level of 5 or 6 percent of payroll over a decade as its work force ages. It is quite another to have the contribution rate jump from nothing for several years to 7 or 8 percent of payroll…With such precipitous changes in plan funding requirements, some sponsors will not continue to support their plans.[6]

The Council believes that it is time for this Committee and the Congress as a whole to reexamine the rules for plan funding. It makes absolutely no sense that companies were not able to provide a strong financial cushion in times of economic plenty, and it is counterproductive to the overall economic health of this country that companies that are struggling to put scarce capital to productive use in the current downturn are being saddled with exorbitant required pension contributions. The common sense approach would be to alter the pension funding rules so that employers can fund their plans in times of economic strength and weather economic downturns without imposition of extreme funding requirements.

Tied up in discussions of the current state of plan funding is the financial condition of the Pension Benefit Guaranty Corporation. As you know, Mr. Chairman, the PBGC's 2002 Annual Report showed the agency in a deficit position for the first time since 1995. In urging caution and prudence in

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[6] Schieber, Sylvester J. 1996. "Proposals for Retirement Policy Reform: Ensuring Our Workers' Retirement Security." Testimony before the Senate Labor and Human Resources Committee Aging Subcommittee, Washington, D.C.

responding to the PBGC's current situation, I want to underscore that the Council has always predominantly represented companies with very well-funded plans. For example, our membership does not include any companies in the steel industry. As an organization representing premium payers who support the PBGC system, the Council has been at the forefront of past Congressional efforts promoting strong funding standards that ensure that the weakest plans would not be able to terminate their plans and impose their liabilities on the rest of the PBGC premium payers. Simply stated, the Council has no incentive to trivialize any problems at the PBGC that will come back to haunt us if other companies are not able to keep their promises to their retirees.

Thus, while the deficit revealed in the 2002 annual report is certainly to be considered very seriously, it does not necessarily indicate an urgent threat to the PBGC's viability. Indeed, the PBGC operated in a deficit position throughout much of its history. Nor does the shift from surplus to deficit over the course of one year suggest the need to change our pension funding or premium rules in order to safeguard the health of the PBGC. In particular, the Council is unlikely to support any proposal that would unwisely penalize prudent and proven plan asset allocation strategies or firms undergoing financial stress. We note that, as the agency stated in its report, the insurance program's total assets are in excess of $25 billion and it should be able to meet current and expected obligations for years to come.

Certainly if the financial position of the agency continues to decline in forthcoming years, the Council would join with policymakers and all other stakeholder groups to re-examine the PBGC's financing structure and ensure that a disturbing situation does not become a crisis. The financial condition of the PBGC should, of course, be monitored closely. At this point in time, we believe the best way to ensure the agency's financial position is to keep as many employers as possible committed to the defined benefit system. The urgently needed policy changes we are advocating today will help achieve this aim and ensure that the PBGC continues to receive a steady stream of premium income from defined benefit plan sponsors.

Pension Interest Rate Reform

Clearly the action most urgently needed to improve the health of the defined benefit system and stem the increasing number of defined benefit plan terminations is for Congress to enact a permanent replacement for the 30-year Treasury bond rate currently used for pension calculations.

Under current law, employers that sponsor defined benefit pension plans are required to use 30-year Treasury bond rates for a wide variety of pension calculations. Yet the Treasury Department's buyback program and subsequent discontinuation of the 30-year bond has driven rates on these bonds to a level significantly below other conservative long-term bond rates. The result has been an artificial inflation in pension liabilities, often by more than 20 percent. As a result of these inflated liabilities, employers confront inflated required pension contributions and inflated variable premium payments to the PBGC. Due to the nature of the pension funding rules, where required contributions do not increase proportionally with increases in liabilities and decreases in funding levels, a number of employers face dramatic increases in their pension funding obligations.

The low 30-year Treasury bond rates have the same inflationary effect on lump sum payments from defined benefit plans that they have on the funding and premium obligations. In other words, the low 30-year bond rates have produced artificially inflated lump sum payments to departing employees. While these inflated lump sums may appear to redound to the benefit of the affected employees, the reality is that the drain of cash from plans as a result of these artificially inflated payments jeopardizes the financial position of the plan. Artificially inflated lump sums also deter employees from taking their benefit in an annuity form of payment, with the protections such form offers against spousal poverty and outliving one's financial resources. The cold reality is that departing employees are taking a benefit payment which is far greater than what the plan had been expected to pay. This forces the employer sponsor to make higher cash contributions thus driving up the plan's cost. The higher the cost of the plan, the greater the visibility within the company's internal budget environment and the greater the pressure to justify the plan's cost/benefit to the company as a whole.

The financial ramifications of the low 30-year bond rates have led increasing numbers of employers to freeze their defined benefit plans. Such freezes result in no additional pension accruals for current workers and no defined benefit program whatsoever for new hires.

Congress included short-term relief from inflated funding and premium requirements in the Job Creation and Worker Assistance Act of 2002. The Council wishes to thank you, Mr. Chairman, and Senator Baucus for your leadership in providing assistance, which gave employers some short-term but quite meaningful relief. As you know, however, this relief was not comprehensive in nature and expires at the end of this year. It is therefore imperative for Congress to enact <u>permanent</u> and <u>comprehensive</u> pension interest rate reform as soon as possible. This effort must involve selection of a substitute long-term interest rate for use by pension plans in lieu of the 30-year Treasury bond rate. Recently, in letters submitted to you, Mr. Chairman, and Ranking Member Baucus, the Council outlined a set of principles that should guide legislative reform of the 30-year Treasury bond interest rate for pension calculations. The key principles are as follows:

- **Adopt a Comprehensive Solution**. It is imperative that permanent interest rate reform revise the rate for <u>all</u> pension calculations required by the Internal Revenue Code (Code) and ERISA that are currently dependent on the 30-year Treasury bond rate. This comprehensive replacement of the 30-year Treasury bond would affect not only pension funding and premium calculations but also calculations affecting the valuation of lump sums and maximum benefits payable from defined benefit pension plans.

- **Use a Consistent Rate**. It is important that the same new benchmark be used for all of the Code and ERISA pension calculations currently dependent on the 30-year Treasury bond. Use of differing interest rates for different pension calculations (particularly for funding and lump sum purposes) could create severe financial instability in plans.

- **Select a Benchmark that Tracks the Return on a Conservatively Invested Portfolio**. We recommend that the new benchmark track the returns expected on a pension plan portfolio conservatively invested in long-term corporate bonds. Such a benchmark is one that the PBGC could meet or exceed through its own investing in the event that it assumes the liabilities of the pension plan.

- **Use a Blend of Corporate Bond Indices as the New Benchmark**. The most effective way to track the return of a portfolio conservatively invested in corporate bonds is to select an actual corporate bond index as the replacement for the 30-year Treasury bond rate. To avoid dependence on a single bond index and to replicate the breadth of the long-term corporate bond market, we recommend that the substitute for the 30-year rate be a blend of several different leading corporate bond indices (giving the Treasury Department flexibility to modify the specific component indices if necessary).

- **Use the New Rate for Lump Sums but Provide a Transition Period**. As noted above, the current law requirement to use the very low 30-year Treasury bond rate to value lump sums artificially and substantially inflates the value of these payments. This inflationary effect has contributed to the large number of pension plan participants who take their benefits in lump sum rather than annuity form. (The low 30-year Treasury bond rates have no inflationary effect on the value of plan annuities.) This artificial encouragement of lump sums -- and artificial discouragement of annuities -- is unsound retirement policy. Participants should be encouraged to select the plan distribution option that works best for them and their families and should not be given an artificial economic incentive to choose one over the other. That being said, the switch to the new interest rate should be phased in so that lump sum values are not changed precipitously for participants on the verge of retirement.

- **Preserve the Existing Interest Rate Averaging and Corridors**. Given the urgency of enacting a replacement benchmark for the 30-year Treasury bond, we recommend that the existing interest rate averaging mechanisms and corridors generally be maintained. Such an approach – in which the new blended corporate bond index is plugged into the existing statutory structure as a replacement for the 30-year bond rate – is the simplest approach and will facilitate prompt enactment of permanent reform.

We cannot over-emphasize the urgency of enacting this permanent, comprehensive reform nor the degree to which achieving this reform is related to stemming the decline in defined benefit plans. Action is needed by late spring in order to convince employers currently struggling with the difficult decision of whether to freeze or terminate their plan that help is on the way. Uncertainty about what the future required interest rate will be is also contributing to stock market instability as companies cannot accurately predict their future pension liabilities and costs. The Council is committed to working with Congress and with groups from across the ideological spectrum to enact the permanent, comprehensive pension interest rate reform so necessary for defined benefit plans to remain viable.

Making the 2001 Pension Reforms Permanent

The Council is very gratified that in recent years Congress has recognized disturbing trends in defined benefit plan sponsorship and has begun to establish a more supportive policy environment for defined benefit pensions. Mr.

Chairman and Ranking Member Baucus, you led these efforts with the Retirement Security and Savings Act of 2001 (S. 742 in the 107th Congress), which was ultimately enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. This legislation contained a number of very positive changes to the rules governing defined benefit plans. Correcting a series of past revenue-driven restrictions enacted by Congress, the Grassley/Baucus legislation repealed an artificially low cap on pension funding that had complicated pension budgeting and financing. It also increased the benefits that can be earned under – and paid from -- qualified defined benefit pension plans so that these plans remain an attractive vehicle for employers to sponsor in our voluntary pension system. The Grassley/Baucus legislation also simplified a number of the most complex rules applicable to defined benefit plans, making these plans somewhat easier to administer, particularly in the context of mergers and acquisitions.

However, these pension changes included in the 2001 tax law need to be made permanent. This step will encourage and support defined benefit pension plans. Sound pension policy depends upon truly long-range planning and budgeting, for both employees and employers, and this is difficult to achieve given that all of the recent positive reforms are scheduled to evaporate come 2011. Consistency and supportiveness have too often been lacking in our nation's policy toward defined benefit pension plans, but by making the 2001 pension changes permanent, Congress can realize these goals and help to restore the health of our nation's defined benefit system.

Unfinished Pension Reforms from the Pension Reform Legislation

Additional changes to our pension laws that would aid defined benefit pensions were contained in the Grassley/Baucus pension legislation but were not enacted as part of the final 2001 tax law due to application of the Byrd Rule. Mr.

Chairman, you and Ranking Member Baucus included these reforms in the National Employee Savings and Trust Equity Guaranty Act that was passed unanimously by this Committee last July. These reforms would make defined benefit plans a more attractive vehicle for small employers through pension insurance premium relief and simplified reporting. They would create fairness for defined benefit plan sponsors by allowing the PBGC to pay interest on premium overpayments. Finally, they would help to simplify and rationalize defined benefit plan administration through a number of regulatory reforms.

We encourage you to enact these important remaining items from the Grassley/Baucus pension legislation this year in order to take another important step to support and encourage defined benefit pensions.

Hybrid Plan Clarification

One notable bright spot in the defined benefit plan landscape in recent years has been the development of what are known as hybrid defined benefit plans, the most common variety of which is the cash balance plan.[7] These plans have proven popular with employees and employers alike. While they offer the benefits of a traditional defined benefit plan (employer funding and risk-bearing, federal guarantees, the option of annuity benefits), they do so in an individual

[7] The cash balance design combines features of a traditional defined benefit pension with those of a defined contribution plan such as a 401(k), hence the term "hybrid." In a traditional defined benefit plan, an individual's pension is generally determined by a formula incorporating the employee's years of service and pay near retirement. The benefit in this traditional pension is expressed in the form of a lifetime annuity (stream of income) beginning at normal retirement age, which is typically 65. In a cash balance plan, an individual's pension is generally determined by an annual benefit credit (typically a percentage of pay) and an annual interest credit (an annual rate of interest that is specified by the plan). These benefit and interest credits are expressed as additions to an individual's cash balance account. These accounts grow over time as the benefit and interest credits accumulate and compound. Benefits in a cash balance plan are ultimately paid out in the form of a lifetime annuity or a lump sum.

account form that is more easily understood and therefore more easily integrated into the employee's overall retirement planning. Cash balance plans also offer the benefit of portability since benefits can be rolled over to an employee's next workplace retirement plan or to an Individual Retirement Account. In addition, they offer a more even accrual pattern than traditional defined benefit plans (where significant benefit accruals are dependent on long service, producing disappointing results for employees who switch jobs several times during their careers). The bottom line is that the transparency, portability and level accruals of cash balance plans often make these hybrid defined benefit plans a better fit for the retirement needs of today's mobile workforce than the traditional defined benefit pension.[8] In addition, unlike defined contribution 401(k) plans, these hybrid plans do help support the PBGC system through regular premium payments.

Unfortunately, the rules applicable to defined benefit plans have not been updated to reflect the development and adoption of hybrid pension plans, leaving a number of pressing compliance issues regarding hybrid plans unresolved. In recent months, the relevant regulatory agencies, led by the Treasury Department, have begun administrative actions to address these unresolved issues.

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[8] Congress devoted significant attention to conversions from traditional defined benefit plans to cash balance plans during the 106th and 107th Congresses. It was understandably concerned about the information employees received regarding these conversions and how certain, discrete groups of workers were affected by the change in plan design. These concerns led to enactment of an expanded notice requirement as part of the 2001 tax law, which will ensure that all employees receive the information they need to understand these conversions and the effect on their pension benefits.

We salute the agencies for their focus in this critical area and for their commitment to resolving these complex but vitally important issues. Notwithstanding the controversy associated with some of these hybrid plan issues, we urge Congress and the members of this Committee to allow the pending regulatory processes to continue. Hybrid plans are a source of real vitality in our defined benefit system today and have proven themselves to be the most effective way to deliver defined benefit plan advantages and protections in a way that meets the needs of today's mobile employees. We must arrive at a legal regime that encourages these plans through rules that acknowledge their unique features.

The Next Generation of Pension Reform

With the enactment of the many positive Grassley/Baucus pension reforms as part of the 2001 tax law, the Council has spent a good deal of time over the past year developing additional recommendations to further strengthen and expand the employer-sponsored retirement system. A number of these recommendations focus on ways to revitalize our defined benefit system and many of the defined benefit reforms I have already discussed today top our list of recommendations. Thus, we believe achieving permanent and comprehensive pension interest rate reform, making the 2001 pension reforms permanent, enacting the unfinished Grassley/Baucus pension changes, and allowing the regulatory process regarding hybrid plans to continue are the most important steps Congress can take to improve the health of our defined benefit system.

Yet there are other reforms that the Council believes would help strengthen defined benefit pensions. Let me share a few with you today.

- First, the Council believes Congress should help to make defined benefit pension plans a more useful mechanism for the financing of retiree medical coverage. Pension benefits are often used to meet health costs in retirement and we believe certain tax changes would help employees do this more efficiently. At many companies today, employees are asked to bear a share of the cost of retiree medical coverage. Yet if these employees are receiving a pension benefit and wish to pay their retiree medical premium with these funds, the position of the Internal Revenue Service appears to be that these workers must pay tax on the pension benefit and then pay the premium with after-tax dollars. We recommend that Congress allow employees to direct the appropriate portion of these pension payments to pay retiree medical premiums on a pre-tax basis (as active employees may do with salary to pay health premiums). This will allow employees to pay these premiums with pre-tax dollars, helping to alleviate one of the primary financial pressures faced by many older Americans.

- Second, the Council believes that a legislative solution is necessary to address the growing administrative burdens attributable to "lost participants", i.e., participants with relatively small benefits who cannot be located by plans. The cost for plans of maintaining records of these benefits and searching for the participants is significant, and a solution needs to be found. The Council believes that one option to explore is a material expansion of PBGC's missing participant program to apply to plans that have not terminated.

- Third, the Council recommends further simplification of the many complex rules governing defined benefit plans, many of which achieve little from a policy perspective but can make pension plan administration both more complicated and more costly.[9]

The Council hopes to work with you Chairman Grassley and Ranking Member Baucus, and with other leaders in Congress to see these additional defined benefit reforms included in upcoming pension reform legislation.

Pension Accounting

Before closing, we would like to raise one emerging issue that could have profound consequences for the U. S. defined benefit pension system. That issue involves the accounting treatment of pension income and expense on company financial statements. The current rules governing pension accounting have been criticized by some and are under review by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).

In particular, these critics attack the amortizing of pension asset gains and losses over time and advocate for immediate recognition of asset and liability experience. The Council is concerned that changes to the current accounting rules for pensions may present a serious threat to the employer-sponsored defined benefit pension system. Under the current accounting standard for

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[9] What follows are several examples of defined benefit plan complexity in need of reform and simplification. Today when a defined benefit plan obtains from a participant a waiver of the qualified pre-retirement survivor annuity (QPSA) (with spousal consent) and the participant is younger than 35 years old, the plan must seek another waiver from the same participant (again with spousal consent) after he or she has attained age 35. Another example of needed reform is legislation to further facilitate the use of new technology in plan administration. This use reduces costs and improves accuracy, thereby clearly improving administrative efficiency. A final example is legislation that reduces unnecessary burdens on the many defined benefit plans that use base pay (or rate of pay) in their benefit formula. Current law requires such plans to perform complex testing not otherwise necessary. The Council would be pleased to share with interested

determining pension cost, reported expenses or income does not track with the actual experience during the particular year. Rather, expenses are allocated in a method designed to track the long-term nature of the pension obligation and income is estimated using expected long-term returns.[10] Critics claim that the use of smoothing techniques for expenses and an expected rate of return on assets unfairly reports pension income (or a lowered pension expense) at a time when asset values have actually declined. They recommend that companies adopt a 'mark-to-market' approach in which the full fluctuation in the value of the pension expense or income is reflected each year. Yet such an approach would create significant fluctuations in the value of pension expense and produce extreme and unnecessary volatility in the reporting of annual net income.

The IASB has initiated a project that, tentatively, would prohibit the use of smoothing techniques for pension accounting purposes, and the FASB is

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members of the Committee our other recommended regulatory simplifications in the defined benefit area.

[10] In 1985, FASB adopted Statement of Financial Accounting Standards No. 87 (SFAS 87), which requires plan sponsors to allocate the cost of future retirement obligations over the working lifetime of employees in a reasonable manner. The purpose of SFAS 87 is to recognize the long-term nature of the pension plan, reduce short-term volatility in the annual expense, promote consistency over time and recognize the compensation cost of a pension over the employee's service. SFAS 87 requires plan sponsors to make a reasonable current estimate of pension costs. These are estimates because the actual pension payments may not be incurred for decades into the future because employees may work for 20 or 30 years into the future and then receive payments over an additional 20 or 30 years. In the process of making this valuation, pension asset investment performance is taken into account by using an estimate of the expected earnings.

[10] (continued) SFAS 87 does not require a specific expected rate of return to be used, but plan sponsors can determine a reasonable estimate in part based on historical performance and the plan's investment philosophy. This estimate represents the expected long-term rate of return on the portfolio, i.e., it is not meant to be the expected return for the current year. Differences between the expected rate of return and the actual returns are then spread over average future service, and other techniques to smooth volatility are also employed.

undertaking a review of SFAS 87 and its 'perceived deficiencies.' In addition, FASB plans to work closely with the IASB to harmonize accounting regimes.

There have been significant international repercussions from pursuit of the 'mark-to-market' approach. The accounting standard-setting body in the United Kingdom adopted Financial Reporting Standard 17 (FRS 17), which utilizes such an approach. Under FRS 17, projected benefit liabilities and the plan's assets are entered directly on the company's balance sheet. All annual changes to assets and liabilities are immediately recognized in the income statement. All U.K. companies were to comply by June 2003, but recently the compliance deadline was extended. In a recent survey by the National Association of Pension Funds, a British trade group, 75% of British pension funds responded that they are considering terminating their pension plans. Some employers have already begun terminating their plans and transferring their liabilities to insurance companies and others have just frozen the plans by not offering new accruals. FRS 17 is significant not only because it provides a glimpse of the likely effect on American pension plan sponsorship of adoption of a 'mark-to–market,' but because the former head of the U.K. accounting standards body responsible for FRS 17 is now chair of the IASB.

Sponsors of defined benefit pension plans understand that pensions are a long-term commitment. While a company can terminate a pension plan at any time, the operation of an ongoing pension plan is made with a long-term perspective in mind. Because of the long-term nature of a pension plan and because of the accounting requirement to place a current value on pension obligations that occur far into the future, the valuation determination must take into consideration the investment performance of assets over an extended period of time. As there is no reason to assign different rates of performance to different periods of time, the use of an average or smoothed asset return assumption is appropriate. Moreover, the use of such a smoothed expected rate of return enables orderly planning and somewhat predictable costs for the employer.

The use of an average expected rate of return does not mean that actual investment returns are ignored; full recognition of differences in the expected and actual experience is only delayed. Current expected rates of return reflect all possible outcomes, including the bull markets of the 1990s, and also take into account regular downturns in asset prices. Similarly, the rates of return used for pension plans in the 1990s did not then reflect the huge returns pension assets were actually earning at that time.

Shifting to an approach that immediately recognizes asset gains and losses would dramatically increase the variability of pension expense and produce significant new volatility in annual corporate income levels. As a result, plan sponsors may respond by shifting pension assets out of equities and into bonds. Such a move would result in the plan sponsor experiencing higher costs for maintaining the plan in the long-term because they would no longer be reaping the benefit of an equity premium in the asset returns. Even worse, many plan sponsors may react by terminating their plans because they simply cannot accept having corporate income levels subject to unpredictable and uncontrollable shifts in the value of pension assets.

Moreover, it is not clear how investors would gain from a 'mark-to-market' approach. Over the long-term, pension plan costs are generally a small part of total compensation, and the 'mark-to-market' approach does not reflect the long-term nature of the pension commitment. As one commentator noted, "the fact that a DB pension plan can be terminated and its assets and liabilities liquidated is no reason to value those assets and liabilities as if the plan were about to terminate. The logical extension would be that since the company could sell or liquidate every one of its components, all components should be valued at their sale or scrap value."[11] Markets and financial analysts have enough savvy and experience with SFAS 87 to enable reasonably accurate company valuations.

Conclusion

Mr. Chairman and Ranking Member Baucus, I want to thank you once again for calling this hearing on what the Council believes to be one of the most important components of our nation's retirement system and for examining some of the most important retirement policy questions we as a nation face today. The Council feels strongly that we must ensure that both traditional and hybrid defined benefit plans remain viable choices for employers so that companies can select the pension plan design most suited to the needs and wishes of their workforce. Defined benefit plans offer unique advantages for employees, but without prompt action by Congress we fear these plans will increasingly disappear from the American pension landscape.

Thank you very much for the opportunity to appear today and I would be pleased to answer whatever questions you and the members of the Committee may have.

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[11] Klieber, Eric. J. "Pension Valuation Needs More Disclosure, Not A New Formula," *Contingencies*, September/October 2002, pp. 33-36.