

## **DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS**

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CONTACT: Mary Diamond  
(202) 622-2960

### **Testimony of Assistant Secretary of Treasury Mark J. Warshawsky before the United States Senate Committee on Finance**

Good afternoon Chairman Grassley, Ranking Member Baucus, and members of the Committee. I appreciate the opportunity to discuss the Administration's proposal to reform and strengthen the single employer defined benefit pension system. In my testimony, I will focus on the proposal's funding rules, in particular, the calculation of the funding targets.

The single employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action, ultimately the insurance system will simply not have adequate resources to pay all the benefits that it owes to the one million workers and retirees currently owed benefits who were participants of failed plans and to the beneficiaries of plans that fail in the future.

The Administration believes that current problems in the system are not transitory nor can they be dismissed as simply the result of restructuring in a few industries. The cause of the financial problems is the regulatory structure of the defined benefit system itself. Correcting these problems and securing the retirement benefits of workers and retirees requires that the system be restructured. Minor tinkering with existing rules will not be sufficient. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system to make it financially sound.

A defined benefit pension plan is a trustee arrangement under which an employer makes a financial commitment to provide a reliable stream of pension payments to employees in exchange for their service to the firm. One cannot expect that such obligations will be honored consistently if they are allowed to remain chronically underfunded as they are under current law. The incentives for financially sound plan funding must be improved or we will continue to see pension plans terminating with massive amounts of unfunded benefits. These unfunded benefits are costly both to participants because many lose benefits and also to other pension sponsors because, they are likely bear the higher costs that such underfunding imposes on the insurance system through even higher premiums.

The goal of the Administration's proposed defined benefit pension reform is to enhance retirement security. The reforms are designed to ensure that plans have sufficient funds to meet accurately and meaningfully measured accrued obligations to participants. The current defined benefit pension funding rules – which focus on micromanaging annual cash flows to the pension fund -- are in need of a complete overhaul. The current rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The current rules:

- Measure plan assets and liabilities inaccurately.
- Fail to ensure adequate plan funding.
- Fail to allow sufficient contributions by plans in good economic times, making minimum required contributions rise sharply in bad economic times.
- Permit excessive risk of loss to workers.
- Are burdensome and unnecessarily opaque and complex.
- Do not provide participants or investors with timely, meaningful information on funding levels.
- Do not generate sufficient premium revenues to sustain the PBGC.
- Create a moral hazard by permitting financially troubled companies with underfunded plans to make benefit promises they cannot keep.

The President's solution to these issues is to fundamentally reform the rules governing pension plan funding, disclosure and PBGC premiums, based on the following three simple principles:

- Funding rules should ensure pension promises are kept by improving incentives to fund plans adequately.
- Workers, investors and pension regulators should be fully aware of pension plan funding status.
- Premiums should reflect a plan's risk and ensure the pension insurance system's financial solvency.

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and as a result will moderate future insurance costs that will be borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding. We have

proposed a fundamental reform of the treatment of defined benefit pension plans, one that we believe will change plan sponsor behavior, ultimately result in better funded and better managed defined benefit pension plans, and secure benefits for workers and retirees.

The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund-up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

Some key features of the proposed funding rules:

- *Funding based on meaningful and accurate measures of liabilities and assets.* The proposal provides funding targets that are based on meaningful, timely, and accurate (using the yield curve for discounting is a central component of this proposal) measures of liabilities that reflect the financial health of the employer.
- *Accrued benefits funded.* Sponsors that fall below minimum funding levels will be required to fund up within a reasonable period of time. The proposal requires a 7-year amortization period for annual increases in funding shortfalls. There will be restrictions on the extension of new benefit promises by employers whose plans' funded status falls below acceptable levels. Benefit restrictions will limit liability growth as a plan becomes progressively underfunded relative to its funding target.
- *Plan sponsors able to fund plans during good times.* Many believe that the inability of plan sponsors to build sufficiently large funding surpluses during good financial times under current rules has contributed to the current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. And every plan will be allowed to fund to a level of funding corresponding to the total cost of closing out the plan. Under our proposal, allowing plan sponsors the opportunity to prefund and therefore limit contribution volatility is a critical element.

Some argue that the best way to enhance retirement security is to create the appearance of well funded pension plans through the use of asset and liability smoothing and increased amortization periods for actuarial losses. In addition, plan sponsors have frequently voiced their dislike of volatile and unpredictable minimum contributions.

Our view is there are significant risks associated with masking the underlying financial and economic reality of underfunded pension plans. Failure to recognize risk because of the use of smoothing mechanisms results in transfers of risk among parties, in

particular from plan sponsors to plan participants and the PBGC. One need only look at the losses incurred by many steel and airline plan participants and PBGC's net position to see this is so.

Moreover, the Administration recognizes that the current minimum funding rules -- particularly the deficit reduction contribution mechanism and the limits on tax deductibility of contributions -- have contributed to funding volatility. Our proposal is designed to remedy these issues; for example, we increase the deductible contribution limit. We feel this additional ability to fund during good times, combined with other provisions of the proposal; for example, increasing the amortization period to seven years compared to a period as short as four years under the current law deficit reduction contribution mechanism, together with the existing freedom of plans to choose pension fund investments, will give plans the tools they need in order to smooth contributions over the business cycle. Plans may choose to limit volatility by choosing an asset allocation strategy or conservative funding level so that financial market changes will not result in large increases in minimum contributions. These are appropriate methods for dealing with risk; it is inappropriate to limit contribution volatility by transferring risk to participants and the PBGC.

#### *Meaningful and Accurate Measures of Assets and Liabilities*

We propose measuring liabilities on an accrual basis using a single standard liability measurement concept that does not distort the measures by smoothing values over time. Within the single method, liability is measured using assumptions that are appropriate for a financially healthy plan sponsor (investment grade credit rated), and alternatively using assumptions that are appropriate for a less healthy plan sponsor (below investment grade) that is more likely to find itself in a position of default on pension obligations in the short to medium term.

On-going liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay. Salary *projections* would not be used in determining the level of accrued benefits. Expected benefit payments would be discounted using the corporate bond spot yield curve that will be published by the Treasury Department based on market bond rates. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the *current liability* measure under current law, plans would be required to recognize expected lump sum payments in computing their liabilities.

The at-risk liability measure estimates the liabilities that would accrue as a plan heads towards termination because of deteriorating financial health of the plan sponsor. At-risk liability would include accrued benefits for an ongoing plan, plus increases in costs that occur when a plan terminates. These costs include acceleration in early retirement, increase in lump sum elections when available and the administrative costs associated with terminating the plan.

The following table provides a summary overview of the critical differences between the ongoing and at-risk liability assumptions.

|                        | <i>Ongoing Liability</i>                               | <i>At-Risk Liability</i>                                                                            |
|------------------------|--------------------------------------------------------|-----------------------------------------------------------------------------------------------------|
| Discount Rate          |                                                        | ----- Yield Curve -----                                                                             |
| Mortality Assumptions  |                                                        | ----- Set by Law -----                                                                              |
| Retirement Assumptions | Developed using relevant recent historical experience. | Acceleration in retirement rates – individuals retire at the earliest early retirement opportunity. |
| Lump Sum Payments      | Developed using relevant recent historical experience. | Acceleration in lump-sum election.                                                                  |
| Transaction Costs      | Not included                                           | Included. Calculated by formula.                                                                    |

Under our proposal, assets will be valued based on market values on the valuation date for determining minimum required and maximum allowable contributions. No smoothed actuarial values of assets will be used as they mask the true financial status of the pension plan.

One aspect of our liability measurement approach that has received a fair amount of attention is the use of the yield curve to discount pension plan liabilities. Accuracy requires that the discount rates used in calculating the present value of a plan’s benefit obligations satisfy two criteria: they must reflect the timing of the future payments, and they should be based on current market-determined interest rates for similar obligations. The Administration proposes to replace the current law method with a schedule of rates drawn from a spot yield curve of high grade (AA) corporate bonds averaged over 90 business days. Discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan’s liability because, by matching the maturity of the discount rate with the timing of the obligation, it properly computes today’s cost of meeting that obligation. Use of a yield curve is a prudent and common practice; yield curves are regularly used in valuing other financial instruments including mortgages, certificates of deposit, etc.

The Treasury Department has developed a corporate bond yield curve that is appropriate for this purpose. Our methodology allows spot yield curves to be estimated directly from data on corporate AA bonds. The process incorporates statistically unbiased adjustments for bonds with embedded call options, and allows for statistically unbiased projections of yields beyond a 30-year maturity. We recently published a white paper detailing our methodology (Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of The Treasury, Office of Economic Policy, White Paper, February 7, 2005) that is available on the Treasury Department web site.

Our budget proposal to reform the calculation of lump-sum benefits also uses the yield curve for calculating the minimum lump sums. We propose to replace the use of a 30-year Treasury rates for purposes of determining lump sum settlements under qualified plans. Using the yield curve to compute lumps sums and the funding required for an annuity eliminates any distortions that would bias the participant’s payout decision.

Under our proposal, lump sum settlements would be calculated using the same interest rates that are used in discounting pension liabilities: interest rates that are drawn from a zero-coupon corporate bond yield curve based on the interest rates for high quality corporate bonds. This reform includes a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law. The new basis would not apply to distributions in 2005 and 2006 and would be phased in for distributions in 2007 and 2008, with full implementation beginning only in 2009.<sup>1</sup>

### *An Example of Discounting Liabilities Using the Yield Curve*

Today, I'll provide an example (economists call this a stylized example) of how the yield curve would be used in discounting pension obligations. The yield curve is used to discount the plans aggregate expected pension payments in each year to participants. The plan administrator has calculated these future pension payments based on the plan's formula for benefits that participants have earned up to the valuation date. As this example shows, once the actuary has determined the plan's annual cash benefit payments summed over all participants in a manner similar to what is done under current law, discounting those payments using the yield curve is quite simple.

Our hypothetical plan consists of three individuals, the 64-year-old Mr. Brown, the 59-year-old Ms. Scarlet, and the 54-year-old Mr. Green. Each of the three retires at age 65 and receives the same pension benefit payment each year until death at age 80. The benefit Mr. Brown has earned to date is higher than Ms. Scarlet's (it is assumed that he has been working longer under the plan) whose expected benefit is in turn larger than Mr. Green's. Mr. Brown's annual benefit under the plan is \$12,000, Ms. Scarlet's is \$9,000 and Mr. Green's is \$6,000.

Chart 1 shows the AA corporate bond yield curve that would be used to discount these benefit payments. The yield curve has interest rates for years 0 to 80. For our stylized example we will only need to use points for the years 1 through 26 because we assume that no participant will draw benefits before year 1 and all payments will be made by year 26. The example applies the yield curve to payments made each year.

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<sup>1</sup> This is a different yield curve phase-in schedule than proposed for the use of the yield curve in discounting pension liabilities for minimum funding purposes.

# Chart 1

Spot Yield Curve  
Corporate AA Bonds  
90 Day Average 12/30/2004

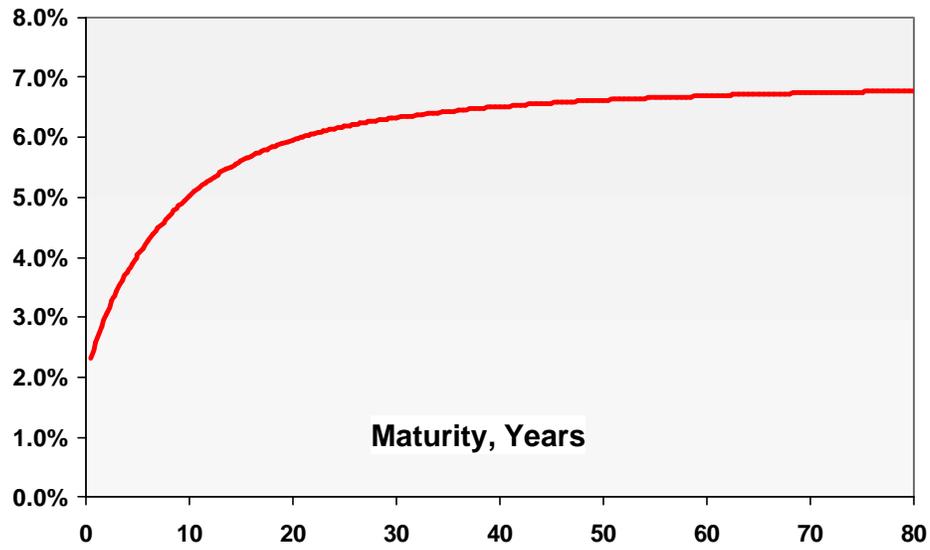
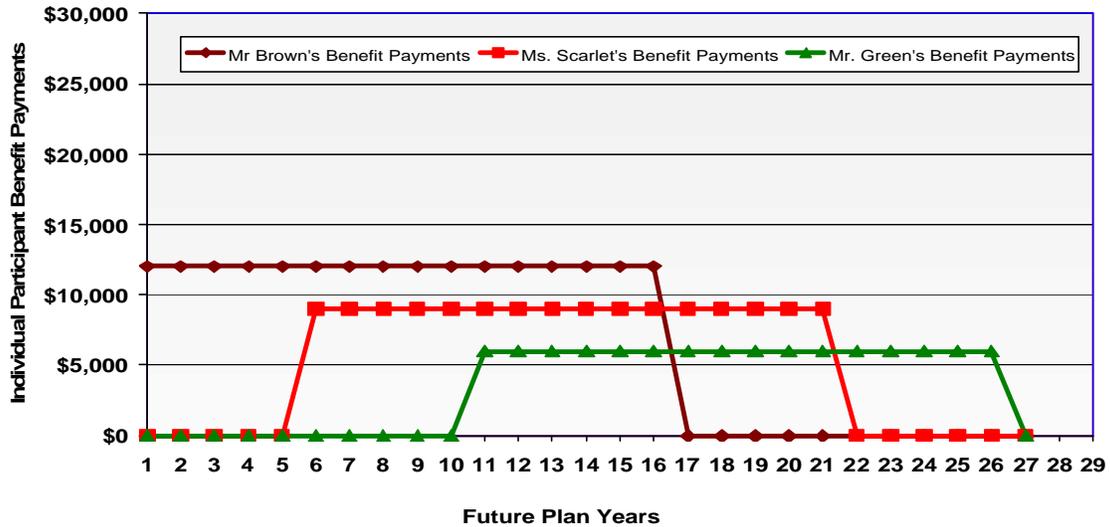


Chart 2 shows the benefit payments that each participant is expected to receive in the future. Chart 3 shows expected total payments that will be made by the plan each year in the future; this is simply the sum of payments to the three individual participants. The total benefit line takes an upward step each time a participant retires and a downward step each time a participant's benefit ends.

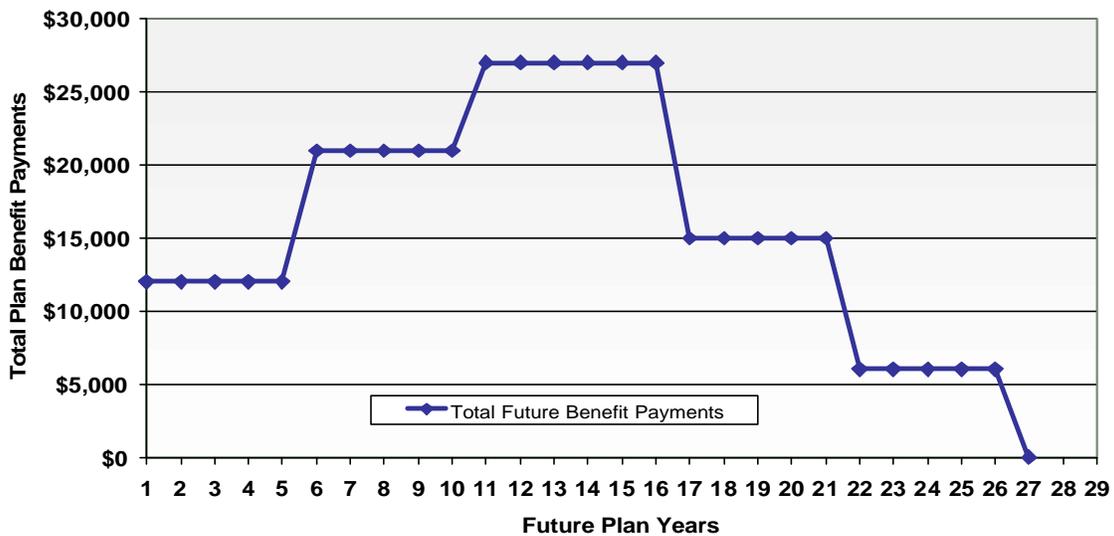
**Chart 2**

**Benefit Payments for a Simple 3 Participant Plan**



**Chart 3**

**Total Future Benefit Payments**  
Sum of Benefit Payments for Brown, Scarlet, and Green



How do we apply the yield curve to discounting these benefit payments?

Let's take years 5, 14 and 20. In year 5, the plan expects to pay \$12,000 in benefits, all to Mr. Brown. The discount rate for that year drawn from the yield curve is 4.03 percent. To compute the present value of the \$12,000, the \$12,000 is divided by 1.218 (one plus the interest rate expressed in decimal form, 1.0403, raised to the 5<sup>th</sup> power), which equals \$9,849.

For plan year 14 the expected benefit payments are \$27,000 (\$12,000 to Mr. Brown, \$9,000 to Ms. Scarlet and \$6,000 to Mr. Green) and the yield curve interest rate is 5.51 percent. To compute the present value, the \$27,000 is divided by 2.119 (1.0546 taken to the 14<sup>th</sup> power) yielding \$12,742. For year 20, the plan expects to pay \$15,000 (\$9,000 to Ms. Scarlet and \$6,000 to Mr. Green) and the discount rate from the yield curve is 5.96 percent. Dividing \$15,000 by 3.183 gives a present value of \$4,713. Note that even though there are three participants in the plan, once their benefit payments during any period are added together only one interest rate is needed to compute the present value for that period. Separate interest rates are not used for every individual participant in the plan.

In order to compute the plan's target liability the plan needs to perform computations like the one above for each payment period from 1 through 27 and sum them together. The liability for this hypothetical plan is \$238,994. In this example, only 26 interest rates are used, one for each year that benefit payments are made. Even if our hypothetical plan had thousands of participants, but payments were made for only 26 years in the future, only 26 interest rates would be needed to compute the plan's liability.

This is, of course, a simplified example. The plan actuary needs to make a number of computations and use his or her professional judgment to determine the plan's future benefit payments each year: the actuary must estimate the probability that a participant will retire at a particular time in the future and must model the probable pattern of payments that will be made for that participant until the participant's death. These computations, already required by current law, are complex, but once the actuary has determined the annual cash benefit payments, discounting those payments using the yield curve is quite simple and can easily be done using a basic spreadsheet program.

As noted above, if Mr. Brown elected to take a lump sum payment rather than an annuity, the minimum value of that lump sum would also be computed using the yield curve. We have assumed that Mr. Brown will begin receiving his annual benefit of \$12,000 next year and will receive the same benefit for 16 years. In order to compute the value of those future payments as a lump sum we would simply discount each period's cash flows using interest rates drawn from the yield curve to find the present value of the benefit in each future period. Then we sum those present values together to yield the minimum lump sum value. In year one, for example, the interest rate drawn from the yield curve is 2.59 percent. If the first \$12,000 payment is made one year in the future its present value would be \$11,697. The present value of the payment made in year 5 would be computed using the year 5 point on the yield curve that is 4.03 percent. Its present

value would be \$9,849. In year 12, the interest rate used to compute the present value is 5.29 percent and therefore the present value of the benefit payment is \$6,465. In total, Mr. Brown's hypothetical lump sum would be valued at \$131,035.

### *Distinction by Credit Rating*

Under the Administration's proposal, the appropriately measured accrued liabilities serve as the plan funding targets. The target funding level for minimum required contributions will vary depending on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below investment grade rated) will use 100 percent of at-risk liability as their funding target.<sup>2</sup>

The goal of pension funding rules is to minimize benefit losses to plan participants. When pension plans default on their obligations, the PBGC is required to make benefit payments to plan participants subject to the guarantee limits. Ultimately, if plan defaults are too numerous, the insurance system will collapse and taxpayers may be called upon to fund the pension promises. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of such defaults. Therefore, it is only natural that pension plans with sponsors that fall into this readily observable high risk category should have more stringent funding standards. The at-risk liability measure is an appropriate funding target for below investment grade companies because the target reflects the plan liabilities that would accrue as a plan heads towards termination.

The table below shows the average cumulative default rate of corporate bond issuers as computed by Moody's Investor's Service (January 2005). This table indicates that, over time, below investment grade firms have a substantially higher likelihood of default than investment grade firms. The table indicates that 14.81 percent of Ba rated firms (just below investment grade) experience a default within 7 years, whereas only 3.12 percent of Baa rated firms (just above investment grade) experience a default within the same period.

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<sup>2</sup> The proposal includes a detailed description of the transition rules that govern the phase in of the higher funding target when a plan changes status from ongoing to at-risk. See the Treasury Blue Book for more information at <http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf>.

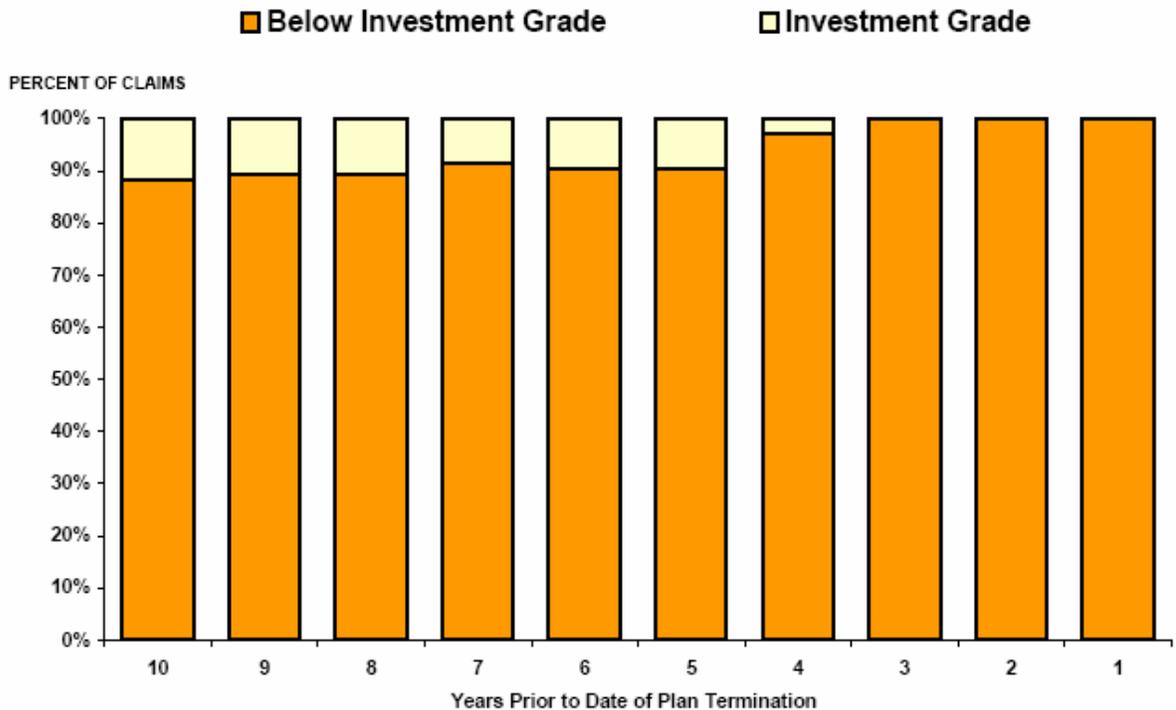
**Average Cumulative Default Rate by Credit Rating, 1970-2004  
Selected Data**

| <i>Years</i> | <i>Moody's Credit Rating</i> |           |          |            |           |          |              |
|--------------|------------------------------|-----------|----------|------------|-----------|----------|--------------|
|              | <u>Aaa</u>                   | <u>Aa</u> | <u>A</u> | <u>Baa</u> | <u>Ba</u> | <u>B</u> | <u>Caa-C</u> |
| 1            | 0.00                         | 0.00      | 0.02     | 0.19       | 1.22      | 5.81     | 22.43        |
| 3            | 0.00                         | 0.03      | 0.22     | 0.98       | 5.79      | 19.51    | 46.71        |
| 5            | 0.12                         | 0.20      | 0.50     | 2.08       | 10.72     | 30.48    | 59.72        |
| 7            | 0.30                         | 0.37      | 0.85     | 3.12       | 14.81     | 39.45    | 68.06        |
| 10           | 0.63                         | 0.61      | 1.48     | 4.89       | 20.11     | 48.64    | 76.77        |
| 15           | 1.22                         | 1.38      | 2.74     | 8.73       | 29.67     | 57.72    | 78.53        |
| 20           | 1.54                         | 2.44      | 4.87     | 12.05      | 37.07     | 59.11    | 78.53        |

Source: Moodys Investor Services, Global Credit Research, Default and Recovery Rates of Corporate Bond Issuers, 1920-2004, January 2005.

The following chart shows that firms generally have a below investment grade credit rating for several years prior to their plan default on pension obligations triggering a claim on the PBGC. This shows 27 largest claims to PBGC for which the series of S&P ratings were available. This suggests that while defaults are certainly not easily predictable (many other plans with below investment grade credit ratings did not default), these are clear warning signs that any responsible regulatory system should take into account. Differentiating funding targets based on credit ratings is appropriate and the investment grade/below investment grade distinction is the most useable and accurate breakpoint.

**Chart 4**  
**Debt Ratings for 27 Large PBGC Claims**



Source: PBGC

*Accrued Benefits Funded*

Under the proposal, sponsors that fall below minimum funding levels would be required to fund up towards their appropriate target in a timely manner. If the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments would be required in amounts that amortize the funding shortfall over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of future amortization payments is less than the funding target, that shortfall is amortized over the following 7 years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.<sup>3</sup>

It is critical to note that while our proposal does away with “credit balances” as currently construed, it does not reduce the incentives to contribute above the minimum. It does, however, prevent underfunded plans from using credit balances for funding holidays. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have resulted in plans having lengthy funding holidays, while at the same time becoming increasingly underfunded. Just marking credit balances to market is not sufficient to solve the problem if underfunded plan are still able to take funding holidays. In the Administration proposal, the focus of the reformed funding rules on stocks of assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Under a reformed set of funding rules, pre-funding adds to a plan’s stock of assets, thereby reducing any current shortfalls or the likelihood of potential future shortfalls relative to appropriately and accurately measured liabilities.

### *An Example of Funding Rules*

Using another example we can demonstrate how minimum contributions would be determined under the funding proposal. Liabilities for the plan are computed over a five-year period using the cash flows and the yield curve depicted in the graphs above. (For simplicity, it is assumed that the yield curve interest rates remain constant over the five-year period.) We then begin with an arbitrarily chosen level of plan underfunding to demonstrate how the amortizations of plan deficits would work. For this example, we simplify and assume that the interest rate charged for amortization of shortfalls is zero. That means that a shortfall increase payment amortized over 7 years is merely the increase divided by 7. The normal cost is also assumed to be zero to simplify the exposition.

In year one, the plan is underfunded by \$18,994. That means that the plan must contribute a minimum of \$2,713, which is the amortization payment for \$18,994 over a seven year term -- in year one and for the next six years -- unless the plan becomes fully funded before year seven.

In year two, the plan’s funding deficit is \$8,000 as a result of increases in both the value of assets and liabilities. Since this new shortfall is less than the value of future contributions (we assume that the plan will make future contributions so their present value effectively becomes an asset) the increase in the shortfall is zero. Under the amortization rules no *new* payment is required; because the plan is still underfunded, however, a second payment of \$2,713 must be made. The amortization rule is designed to encourage plans to fund up quickly in order to protect participants’ pensions. For that reason, the amortization payment of \$2,713 is not reduced even though the plan’s funded status has improved.

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<sup>3</sup> This description draws on the description in the Treasury Blue Book.

In year 3, the funding shortfall increases to \$18,367 because the value of assets has fallen. Because this is \$4,800 more than the value of the remaining amortization payments, a new payment of \$686 is added to the existing payment of \$2,713 meaning that total contributions are \$3,399 in year 3.

In year 4, because of an increase in asset values, the plans deficit falls to \$9,283. This is less than \$14,968, the value of the remaining shortfall payments from year 1 and year 3 so there is no new payment and the required contribution remains \$3,399.

In year 5, asset values rise again and the plan is now fully funded. Because the plan no longer has a funding deficit, no minimum contribution is required and all past amortization payments are cancelled.

**Table 2**  
**Minimum Funding Example**

| <b>Year</b>                            | <b>1</b>         | <b>2</b>         | <b>3</b>         | <b>4</b>         | <b>5</b>         |
|----------------------------------------|------------------|------------------|------------------|------------------|------------------|
| <b>Assets</b>                          | <b>\$220,000</b> | <b>\$242,000</b> | <b>\$225,060</b> | <b>\$236,313</b> | <b>\$250,492</b> |
| <b>Liabilities</b>                     | <b>\$238,994</b> | <b>\$250,000</b> | <b>\$243,427</b> | <b>\$245,596</b> | <b>\$247,656</b> |
| <b>Shortfall</b>                       | <b>\$18,994</b>  | <b>\$8,000</b>   | <b>\$18,367</b>  | <b>\$9,283</b>   | <b>\$0</b>       |
| <b>Value of Remaining Year 1 Pmts.</b> |                  | \$16,281         | \$13,567         | \$10,854         | \$8,140          |
| <b>Value of Remaining Year 2 Pmts.</b> |                  |                  | \$0              | \$0              | \$0              |
| <b>Value of Remaining Year 3 Pmts.</b> |                  |                  |                  | 4,114            | 3,429            |
| <b>Value of Remaining Year 4 Pmts.</b> |                  |                  |                  |                  | \$0              |
| <b>Value of All Remaining Payments</b> | \$0              | \$16,281         | \$13,567         | \$14,968         | \$11,569         |
| <b>Shortfall Increase</b>              | <b>\$18,994</b>  | <b>\$0</b>       | <b>\$4,800</b>   | <b>\$0</b>       | <b>\$0</b>       |
| <b>Minimum Contribution for:</b>       |                  |                  |                  |                  |                  |
| <b>Year 1 Shortfall Increase</b>       | \$2,713          | \$2,713          | \$2,713          | \$2,713          | \$0              |
| <b>Year 2 Shortfall Increase</b>       |                  | \$0              | \$0              | \$0              | \$0              |
| <b>Year 3 Shortfall Increase</b>       |                  |                  | \$686            | \$686            | \$0              |
| <b>Year 4 Shortfall Increase</b>       |                  |                  |                  | \$0              | \$0              |
| <b>Year 5 Shortfall Increase</b>       |                  |                  |                  |                  | \$0              |
| <b>Total Minimum Contribution</b>      | <b>\$2,713</b>   | <b>\$2,713</b>   | <b>\$3,399</b>   | <b>\$3,399</b>   | <b>\$0</b>       |

## *Benefit Restrictions*

Finally, we have proposed benefit restrictions that will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of liabilities when plans are becoming dangerously underfunded in order to ensure that plan participants will collect benefits that they accrue. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in many situations even make benefit improvements. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likely losses faced by participants and large claims to the PBGC. To guard against this type of moral hazard, if a company's plan is poorly funded, the growth in the plan's liabilities should be limited unless and until the company funds them, especially if the company is in a weak financial position.

### *Plan sponsors able to fund plans during good times*

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The importance of these mechanisms that I have described is not simply to force plans to fund-up quickly and reduce the rate at which new obligations accrue. Their importance is also that rational, forward looking managers will respond to these reforms by taking steps to ensure that plans remain well funded on an ongoing basis. The Administration plan matches new responsibilities, to more fully fund pension obligations, with new opportunities – an enhanced ability to pre-fund obligations on a tax preferred basis.

Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed significantly to current underfunding in the pension system. The proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax deductible contributions. Every plan will be allowed to fund to at least at-risk Liability.

The first cushion is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability values fluctuations that occur over a business cycle. Plan sponsors would also be able to build a second funding cushion that allows them to pre-fund for salary or benefit increases.

## *Conclusion*

Defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the

future. We are committed to working with Congress to ensure that effective defined benefit pension reforms that protect worker's pensions are enacted into law.

It has been my pleasure to provide this detailed discussion of some of the critical elements of the proposal. My colleagues and I are available and look forward to discussing the proposal and the motivations for the proposal and answering any additional questions you may have.