AMERICAN ACADEMY *of* ACTUARIES

# Subcommittee on Employer-Employee Relations
# Committee on Education and the Workforce
# U.S. House of Representatives
# 2175 Rayburn House Office Building

## Hearing on:

## Examining Long-Term Solutions to Reform and Strengthen the Defined Benefit Pension System

**Testimony Presented By:**

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**April 29, 2004**

Chairman Johnson, Ranking Member Andrews, and distinguished committee members, I thank you for the opportunity to testify today on "Examining Long-Term Solutions to Reform and Strengthen the Defined Benefit Pension System." My name is Ken Kent, and I am the Vice President of the Pension Practice Council of the American Academy of Actuaries. The Academy is the non-partisan, public policy organization for all actuaries in the United States. In my testimony today, I will address three specific items related to pension funding reform:

- The need for reform;
- The Academy's principles for reform; and
- Opportunities to change our system of benefit delivery

**Do we need reform?**

The need for reform is evidenced by the continuing decline in the number of defined benefit plans. Defined benefit programs are a fundamental vehicle for providing financial security for millions of Americans – unlike other retirement programs, they provide lifetime benefits to retirees no matter how long they live and regardless of how well or poorly they do with their investments. However recent market conditions of combined low interest rates and low market returns have made it difficult for employers to maintain these plans and have instigated more dramatic declines in the number of employees covered under these plans over the past year. There are many contributing factors, including regulatory and administrative burdens derived from years of amendments to ERISA, which have had a long-term detrimental impact. These programs need your support through major reform of the current laws.

**Our Reform Principles**

Leading actuaries volunteered their time and intellectual capital to create a framework of principles that we believe funding reform should meet. We will soon be publishing a paper presenting many ideas on how these principles can be addressed – some of which are included in a summary, which is attached to my written statement.

Let me briefly describe these six principles:

- Solvency – This should be a fundamental objective for funding reform – the rules should move us to a point where assets cover liabilities. They should also address and reward responsible corporate behavior over short-term economic cycles.

- Predictability – Contributions should be more predicable so they can be budgeted in advance. Precision at the cost of rational, predictable results can be expensive for employers and detrimental for employees.

- Transparency – Users of the information should be able to understand the current financial position of the pension plan. However, we should not confuse the need for financial statement disclosure with measurements to identify the funding obligation of a long-term program.

- Flexibility – Sponsors should be encouraged to fund their plans better by allowing them to build up margins in their plans without deduction and excise tax problems and by providing them access to “super surpluses” for other purposes, such as employee benefits, without having to pay a reversion tax.

- Simplicity – The rules should be easier to understand and comply with than the current, complex rules.

- Transition – Sponsors need a smooth transition to the new rules, so they are not forced into freezing or terminating their pension plans.

**Opportunity to update benefit delivery**

Reform is not only a responsibility but also an opportunity to bring our system of retirement security in line with a changing demographic and global business model. There are five areas that can help achieve our current and future needs:

- Put hybrid plans back on the table. Their popularity stems from an ability to meet the needs of participants and employers alike, especially within some industries.

- Provide for phased retirement. The current rules are an impediment. Our workforce can use this gradual process of retirement, and individual flexibility makes these provisions a “win-win” with employers.

- Mirror the opportunity available for defined contribution plans by allowing for employee deductible contributions to defined benefit plans and by allowing employees access to purchase lifetime income security through employer sponsored plans.

- Provide portability. Multiemployer plans provide one time-tested, effective model – IRAs go partway – but the challenge is portability of annuity-type benefits to preserve the intended security. Defined benefits have a critically different function for retirement security over lump sums, through investment and longevity risk pooling. Placing restrictions on lump sums and/or encouraging participants to take annuities are two possible approaches.

- Update the standard retirement age. In the 1930s, when life expectancies were much lower, age 65 was defined as the standard retirement age. Clearly, our society has changed, people are living significantly longer, and this target age should be raised to better align the expectations of the workforce today and in the future.

I appreciate the opportunity to participate in this process on behalf of pension actuaries who have dedicated their careers to helping sponsors provide employees’ financial security on retirement. To these ends, we are currently engaged in:

- Completing a white paper with our ideas on pension reform;
- Analyzing ways to redefine what retirement age should mean; and

- Encouraging the establishment of a national retirement security policy as an overall guiding benchmark.

As we work to further define these principles and alternatives for reform, we will share them with you. Thank you for this opportunity on behalf of the American Academy of Actuaries.

## Pension Funding Reform for Single-Employer Plans[1]

The economic challenges of the past four years have tested U.S. pension funding rules like no other time since the funding rules were enacted. The unprecedented severe combination of declining interest rates and equity values have increased liabilities and decreased asset values simultaneously — cutting funding ratios almost in half between 2000 and 2003.

Different constituencies are unhappy with the pension funding rules, and most would agree that the current rules are unnecessarily complex and lacking in transparency.

- *Employers* assert that the rules create volatile contribution requirements that are counter to their business cycles and that unpredictable results make it difficult to plan ahead.
- The *Pension Benefit Guaranty Corporation (PBGC*) is concerned about its dramatically increased deficit and the funding rules that allow sponsors of underfunded plans to completely offset contributions by a credit balance and not avoid paying variable PBGC premiums. They would prefer that contributions respond quicker to changing economic conditions.
- *Participants* in terminated plans with large benefits were surprised at how poorly funded their plans were, and how much that reduced their PBGC-payable benefit.

**The American Academy of Actuaries'[2] Pension Committee has identified several principles that any revision of pension funding rules should meet.** These principles are the result of an ongoing discussion and are likely to change and evolve as discussions continue. The primary objective of pension funding is solvency. Participants and the PBGC are benefited by well-funded pension plans. Recent proposals by both the Bush administration and Congress recognize that satisfying each of the principles the committee has defined is a balancing act. Members of the committee do not want insolvent plans, nor do they want an over burdensome solution to eliminate defined benefit (DB) plans. Employees could easily be hurt more by a freeze or termination of a DB pension plan than by occasions of insolvency. In addition, PBGC's deficit will be difficult to eliminate if healthy employers drop their pension plans and stop paying premiums to the PBGC. Thus, as typically happens, balance is needed when applying any principles for reform.

There are two likely approaches to reforming the funding rules: incremental or comprehensive. Both have advantages and disadvantages, and both will provide substantial challenges. Incremental change may get enacted sooner, but each change

[1] This paper covers fundamental principles for the reform of single-employer plans. A paper, yet to be published, will examine the reform of multiemployer plans, since those plans are so different.

[2] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

will have opponents that request exceptions and transition rules, increasing the opportunity for future problems. On the other hand, a comprehensive rewrite of the funding rules may take longer to enact and may result in unforeseeable problems that occur only when tested in future economic climates. Whether reform is incremental or comprehensive, all proposals for pension funding should be assessed to see how they meet the following principles:

- **Solvency:** The funding rules should move us to a point where assets cover accrued liabilities. The funding rules could also encourage employers to ensure that assets cover ongoing liabilities.

- **Predictability:** Contributions should be more predictable so they can be budgeted in advance.
    - *Smooth contributions/less volatility:* Contributions should not change radically due to a small change in assets or interest rates.
    - *Accommodate (recognize?) business/economic cycle:* Employers should be able to make larger *c*ontributions in good years than under current rules, so they will not have to contribute large amounts in difficult years.
    - *Better financial risk management:* Plan sponsors should be able to hedge swings in liabilities by holding bonds, which would make contributions more predictable.

- **Transparency:** Users of the information should be able to understand the current financial position of the pension plan and its integration with the sponsors' disclosures.

- **Incentives to fund/flexibility:** Sponsors should be encouraged to fund their plans better by allowing them to build up margins in the plan without deduction and excise tax problems and by providing them access to "super surpluses" for other purposes, such as employee benefits, without having to pay a reversion tax.

- **Avoidance of moral hazards:** The rules should not encourage weak employers to improve benefits at the expense of someone else (e.g., the PBGC, premium payers, or US taxpayers).

- **Simplicity:** The rules should be easier to understand and comply with than the current, complex rules.

- **Transition:** Sponsors need a smooth transition to the new rules, so they are not forced into freezing or terminating their pension plans.

It will be recognized that there are inherent challenges in coordinating several of these items, and of course, no specific legislative approach can be firmed up until the necessary choices are made. We have, however, prepared a table appended to this summary that offers suggestions that could improve each of the matters noted above; this table necessarily includes suggestions that conflict with one another, just as the potential goals do. This should be kept in mind when reviewing the table.

**The Academy's Pension Committee is engaged in the development of an issue brief that expands on the way these principles can be addressed, as well as a more technical white paper that discusses how the current rules and regulations hinder achievement of these principles and offers alternative ways the law can be changed to realign the rules.**

Why should defined benefit plans be encouraged? Defined benefit plans, in particular, can reduce the investment, inflation, interest rate, and leakage[3] risks to employees and eliminate most of the longevity risk through pooling (annuitization). Employees are much more likely to participate in the company DB plan and they are much more likely to get a lifetime income from the DB plan. (Most defined contribution (DC) plans such as 401(k)s rely on voluntary enrollment, and rarely pay out a lifetime income.) In addition, DB plans are better than DC plans at providing the country with some very important advantages, which many people (including some policymakers) will not realize are lost until many years from now, when it is too late to regain them. For example, DB plans create a more financially secure population, reduce welfare expenditures, provide a huge source of efficiently invested assets in our markets, and defer taxable income to the future when it is needed (to reduce the strain on federal resources caused by retiring baby boomers, for example). And finally, DB plans help employers with workforce management issues (and union demands) better than DC plans.

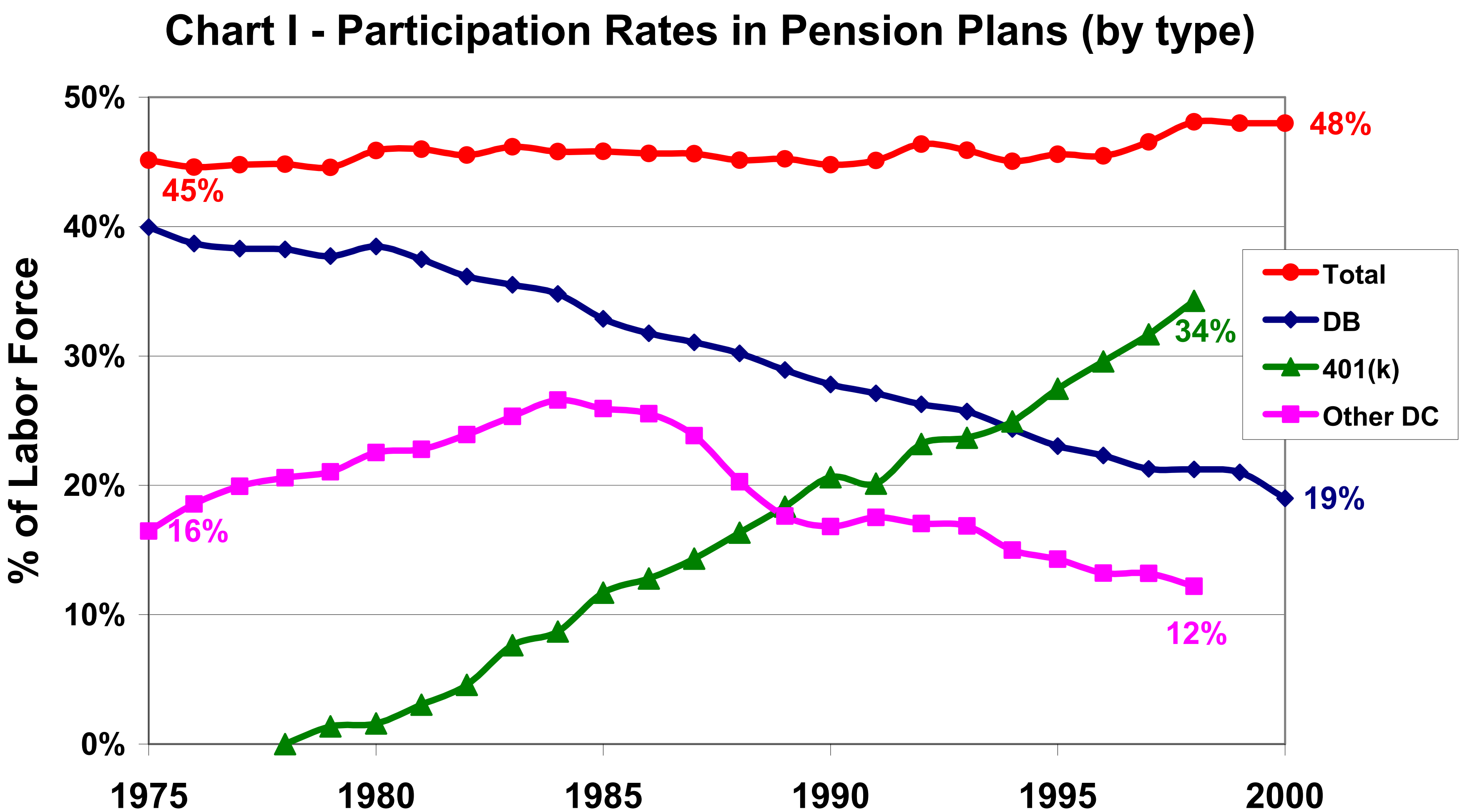
Prior law encouraged DB plans as much as DC plans. This is no longer true. DC plans now have more tax advantages, and the laws regulating them are much simpler and they allow DC plans more flexibility (e.g., pre-tax employee contributions, employer matches, tax advantages for company stock contributions). Thus, any revisions to the funding rules should stop and reverse this trend, or employers will continue to switch to DC plans. Many employers have already done that (particularly ones that were intending to switch to cash balance plans but were too concerned about the current, uncertain legal environment), and many are freezing their DB plans while contemplating moving to DC plans.

We welcome the opportunity to discuss these ideas with you and to work with you in shaping a solution that will balance the needs of employees, employers, the PBGC, and other parties.

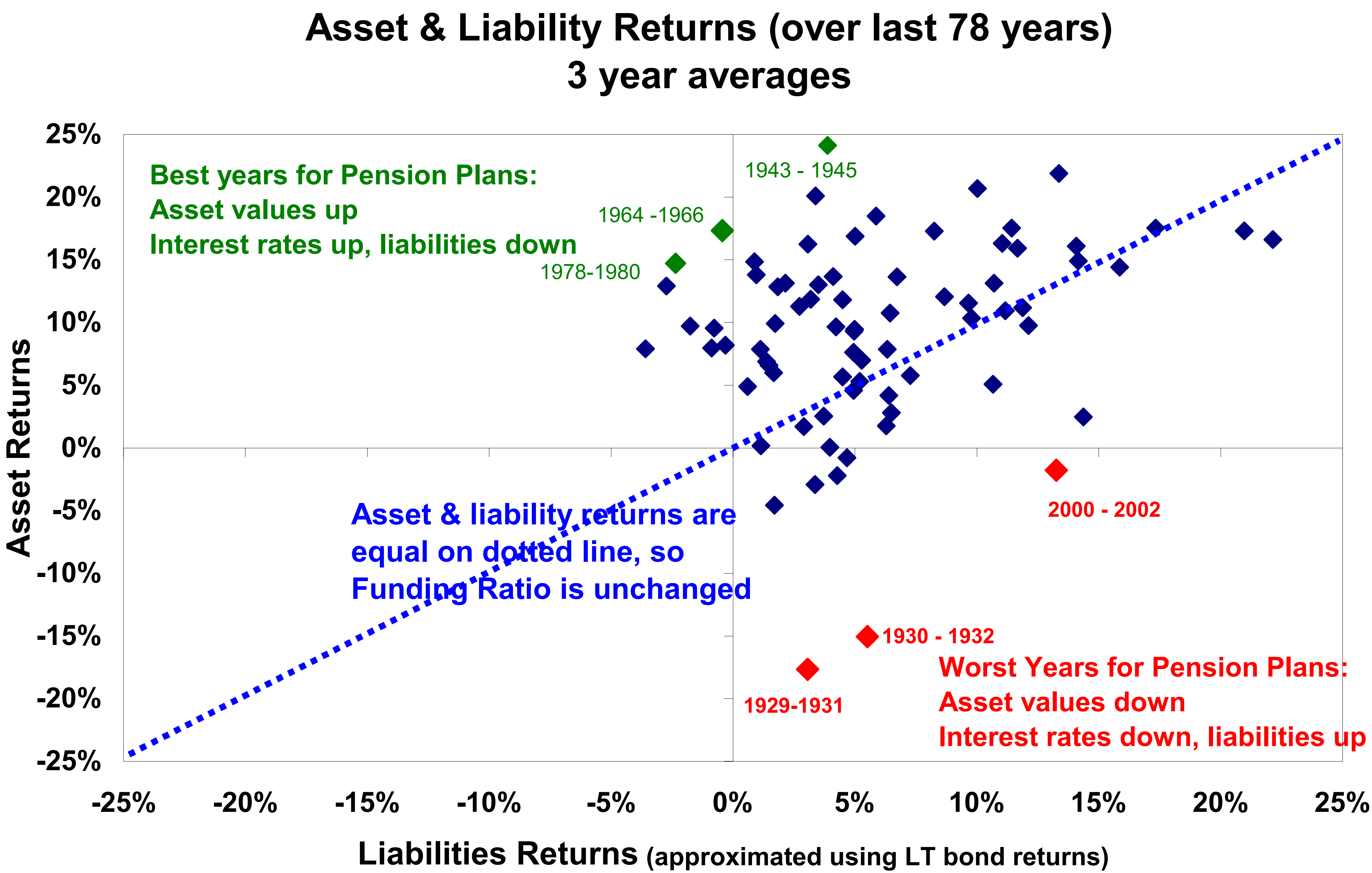
[3] "Leakage" refers to the risk that retirement assets will be withdrawn and spent before the employee retires, and will therefore not be available for retirement income.

<table>
<tr><th>Principles</th><th>Possible Alternatives for Funding Reform (see advantages/ disadvantages in our paper)</th></tr>
<tr><td>Solvency<br>The funding rules should move us to a point where assets cover accrued liabilities. The funding rules could also encourage employers to ensure that assets cover ongoing liabilities.</td><td>• The full funding limit override could be increased to 100 percent of current liability (CL), to ensure contributions and variable premiums up to that amount.<br>• Require a normal cost (or present value of accruals) until assets reach a higher threshold (e.g., the greater of the ongoing actuarial accrued liability or 130% of CL).<br>• Allow or encourage normal cost (or present value of accruals) until assets reach a still higher amount, such as total present value of benefits, a termination liability, or 150% of CL.<br>• Instead of requiring weak sponsors to use mandated retirement assumptions (which can easily be inappropriate), require them to explain the basis of their retirement assumption for CL calculations.<br>• For shutdown benefits that are too difficult to fund, phase-in the guaranteed benefit from shutdown date, charge a PBGC premium for them, or require security for them.<br>• Include lump-sum subsidies in current liability, and allow plans to gradually eliminate the subsidy.<br>• Gradually restrict the use of the credit balance from fully offsetting the contribution for plans funded below a certain level.</td></tr>
<tr><td>Predictability<br>Contributions should be more predictable, so that they can be budgeted in advance.<br><br>Smooth contributions/less volatility<br>Contributions should not change radically due to a small change in assets or interest rates.<br><br>Accommodate business/economic cycle:<br>Contributions could be greater in good years so they can be less in difficult years.<br><br>Better financial risk management<br>Plan sponsors should be able to hedge swings in liabilities by holding bonds, which would make contributions more predictable.</td><td>• Make the deficit reduction contribution (DRC) and regular §412(b) funding rules more similar. For example:<br>- Shorten the §412(b) amortization periods.<br>- Increase DRC “amortization” periods, especially if smoothing in the interest rates is reduced.<br>- Bring the discount rates for the DRC and regular funding rules closer together.<br>• Eliminate the need for the regular funding rules in §412(b) by extending the DRC rule to 100% of CL. Assess whether this will weaken funding in other economic scenarios.<br>• Enable bond-immunized plans to hedge their interest rate risk and contribution volatility by allowing them to elect to use market value of liabilities (in addition to market value of assets), when subject to DRC.<br>• Cap the increase in the minimum contribution at 25% of the plan’s normal cost (or 2% of the plan’s accrued liabilities, if greater)</td></tr>
<tr><td>Transparency<br>Users of the information should be able to understand the current financial position of pension plan and sponsor.</td><td>• Require timely (year-end disclosure as required in financial statements) and meaningful (market value) disclosure of assets, liabilities, and funding ratios to participants if plan is funded below 100% of accrued liabilities.</td></tr>
</table>

| Principles | Possible Alternatives for Funding Reform (see advantages/ disadvantages in our paper) |
|---|---|
| **Incentives to fund/flexibility**<br>Sponsors should be encouraged to fund their plans better by allowing them to build up margins in the plan without deduction and excise tax problems, and by allowing them access to super surpluses for other purposes, such as employee benefits, without reversion tax. | • Improve plan asset margins by increasing deductible limits (e.g., to the greater of 150% of CL and the full funding limit).<br>• Expand the §420 transfer rules to allow super surpluses (above a high threshold) to be used for other employee benefit plans, such as employee health and other retirement plans. Require union approval if pension plan is subject to bargaining.<br>• Let PBGC variable premium be negative to reduce some of the per person premium for very well funded plans. |
| **Avoidance of moral hazards**<br>The rules should not encourage weak employers to improve benefits at the expense of someone else (e.g., the PBGC, premium payers, or US taxpayers). | • Shorten the amortization periods for amendments.<br>• Tighten rules for sponsors whose underfunding is large in proportion to their net worth, earnings, or cash flow. For example: tighten threshold for providing security before allowing benefit improvements; freeze future benefit accruals, grow-ins; and eliminate lump sums if plan is very underfunded.<br>• Allow plans to eliminate lump sums (as long as they replace it with a 20-year-certain joint life benefit).<br>• Improve PBGC's position in bankruptcy proceedings. |
| **Simplicity**<br>The rules should be easier to understand and comply with than the current, complex rules. | • Have just one amortization period or one funding rule.<br>• Disconnect minimum funding rules from maximum deductibility rules.<br>• Allow changes in funding methods whenever desired.<br>• Eliminate quarterly contributions, and require the full contribution by year-end.<br>• Discuss alternatives to the yield curve proposal. |
| **Transition**<br>Sponsors need a smooth transition to the new rules, so that they are not forced into freezing or terminating their pension plans. | • Cap the increase in the minimum contribution at 25% of the plan's normal cost (or 2% of the plan's accrued liabilities, if greater) |

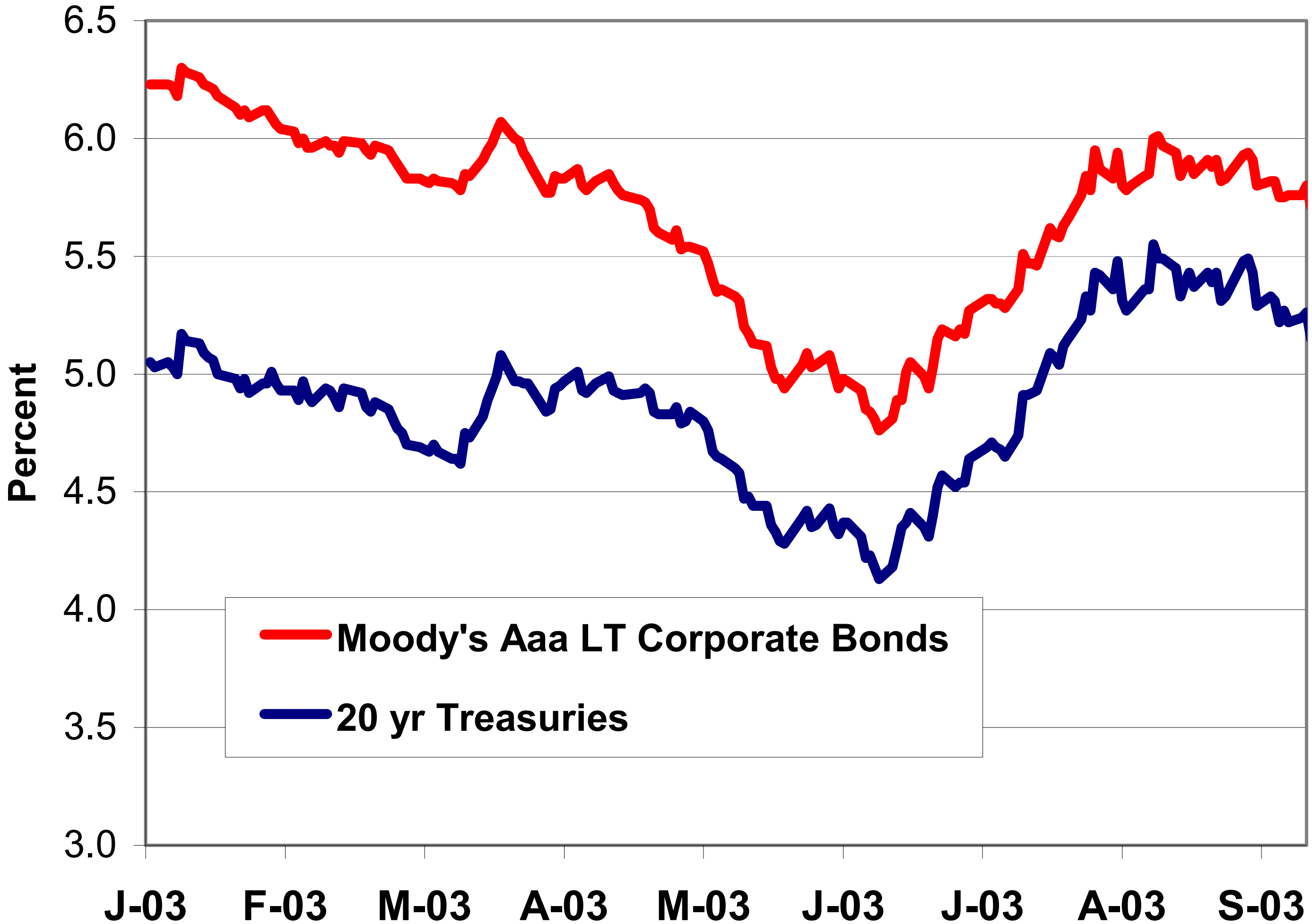



It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4, E8, & E23, and NCS for 1999 & 2000.




This chart show how unusual the past few years have been (only the Depression was worse).
The smoothing rules would work at the other 96% of periods.

# Chart III - Daily Interest Rates




Interest rates increased by 150 basis points in summer of 2003, making contributions volatile and unpredictable - contributions calculated in June 2003 would be dramatically different from those of just 7 weeks earlier, unless funding rules allow smoothing (or plan has duration matching bonds).