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## **ERISA Advisory Council Testimony**

**For the Working Group on Defined Benefit Plan Funding and Discount  
Rate Issues of the Advisory Committee on Employee Welfare and  
Pension Benefit Plans**

**Testimony Presented by:**

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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, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

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The Pension Practice Council of the American Academy of Actuaries and its committees are made up of senior actuaries who work for large and small consulting firms, insurance companies, unions and corporations and provide professional advice representing all types of retirement programs from our nation's largest plans to single entrepreneur arrangements, from not-for-profit organizations to corporations and multiemployer funds. Our Council members are committed to providing objective information and ideas to ensure the viability of our voluntary retirement system and to support the position that defined benefit (DB) retirement programs provide a vital form of retirement security for the American people.

It is a critical mission to see that DB plans are supported and plan sponsors are provided with the incentive to maintain and grow these programs. Years of almost annual amendments to ERISA have continuously increased the administrative burden on those who try to maintain defined benefit programs, putting many employers at a disadvantage. Those companies who sponsor DB plans are now questioning the future of their programs under the current financial strains of the economy, funding and accounting difficulties and the uncertainty they face with this type of plan.

There are many different aspects of today's economic environment that threaten the voluntary DB system. The decline in equity markets and interest rates has simultaneously caused the assets supporting pension funds to decline while increasing an employer's liability. These two forces have dramatically shifted the funded status of most if not all DB plans. Funding requirements have not only increased to compensate for lower investment returns over the past three years, but overnight the decline in 30-year Treasury rates has triggered additional funding under the deficit reduction contribution (DRC) requirement of Internal Revenue Code (IRC) Section 412(l).

With the enormous publicity pension funding and accounting has received in recent months, it is important to remain focused on the long-term goal of providing retirement security for American workers. Working from past testimony, input from the Pension Committee and my own experience, I have developed a framework to help analyze these issues that consists of three separate yet interdependent perspectives:

- Solvency – the ability of a plan to meet its obligation to participants in the event of a catastrophic corporate event such as corporate reorganization or bankruptcy;
- Funding – the systematic accumulation of funds to meet current and future obligations to plan participants;

- Accounting – the appropriate representation of the net obligation particularly for public companies, to allow for the accurate assessment of the organization’s ability to meet this obligation along with its other business financial needs.

The measurement of assets and liabilities to maintain these three perspectives should vary according to the specific needs for each of the audiences who will evaluate the way the plan sponsor is meeting its obligation to participants.

Two of these three perspectives, solvency and funding, are defined by laws and regulations, while the accounting framework is defined for the most part by the Financial Accounting Standards Board (FASB). Each perspective needs to be addressed, considering the applications for the primary audience, but we must also include the ramifications on plan sponsors and participants if we want to develop effective retirement policy. Below we identify areas for consideration in your study.

### **Solvency**

We suggest that the provisions of the IRC Section 412(l), other laws and regulations, as well as the activities of the Pension Benefit Guaranty Corporation (PBGC) can best be described as issues of plan solvency. The defined appropriate discount rate for IRC Section 412(l) is critical for assessing the adequacy of funding. Solvency has become a critical issue because of the decline in assets coupled with the decline in the discount rate used to measure liabilities to determine funded status and potential requirement of deficit reduction contributions.

The PBGC and the plan participants are the primary stakeholders when it comes to plan solvency. They both focus on the plan sponsor’s ability to meet the plan’s obligations to the employees, especially in the case of plan termination. The issue with the 30-year Treasury rate and an appropriate replacement affects funding of DB plans through the calculation of a plan’s funding ratio and potential deficit reduction contribution is specifically an issue of solvency.

There is an urgent need to fix the discount rate, which is currently based on 30-year Treasury rates. The discontinuance of 30-year Treasury bonds causes the laws of supply and demand to increase their price, reducing the rate. In addition, when the Federal Reserve Board dramatically reduces lending rates, it brings all interest rates down to historic lows. The 30-year Treasury rate was adopted as a benchmark to approximate the annuity purchase rate; today it falls well below the current trend. The chart of discount rates at the end of this testimony shows that the maximum permissible rate was less than an annuity pricing rate in 2000 and 2001, and the rate would have been lower in 2002, if it were not for the temporary fix that Congress passed last year.

Without an adequate permanent replacement rate, employers are forced to use drastic measures when addressing the future uncertainty of the funding obligation. There are no statistics for the number of plan sponsors who have already frozen their plans to future accruals, but we all have clients who have frozen their plans and others that will be

forced to freeze accruals in the future if they cannot adequately project reasonable future funding obligations.

The current version of the *Pension Preservation and Savings Expansion Act of 2003* includes the recommended use of a high-quality, long-term corporate bond rate. This legislation has the support of employers and labor, and we find it to be a more realistic and reliable measure to benchmark the true cost of annuities in the market. The bill also retains the use of a rate within the permissible range. While we do not take a position on the specific endpoints, a range is also appropriate because it allows for contribution flexibility.

The Treasury's proposal also endorses the corporate bond rate for two years with a phase-in of a corporate bond yield curve (instead of the average long-term rate) to reflect the duration of pension plan liabilities. The administration argues that the yield curve will better reflect the duration of the liability, resulting in a higher liability for employers with an older workforce. Actually, the yield curve has a relatively small effect on liabilities. A study shows that liabilities for mature plans would only be increased by 2 percent or 3 percent on average, and 5 percent when the yield curve is steepest.

The Treasury argues that the use of the yield curve will be simple and seems to underestimate some of the administrative complexities of incorporating a bond-based yield curve into retirement valuation systems, accommodated with the use of a spreadsheet. Most funding valuation systems are designed to handle many different types of benefit structures, funding methods, and assumption sets. All the programs for such systems will have to integrate this type of change. They must also test each case valuation with test lives to insure the accuracy of this new type of assumption. For solvency testing, the added accuracy of a yield curve will not make the difference between a company that can meet its financial obligation to improve the funded status of its retirement plan and the company that does not have adequate financial resources to do so.

In addition, best actuarial practices would call for using more precise, individually reasonable mortality tables if we are using more precise discount rate measurements. Ironically, using these mortality tables would in many cases completely offset the effects of the bond yield curve. The types of plans that would experience the highest increase in liability when introducing a yield curve would generally be the same plans that would experience the most liability decrease if we were permitted to use collar-based mortality tables. The use of a yield curve would be expensive to implement for small plans, and would complicate compliance with other areas of pension law, which are logically tied to this rate (e.g., lump sum determinations, returns on employee contributions, and cash balance interest credits).

Another consideration in the use of the yield curve is to adequately test the impact on calculating liabilities over differing economic cycles to determine its effectiveness as a measure of solvency. The current crisis in funding is brought on by the correlation of the measure of funded status and deficit reduction contribution requirements in a down economy. The two concepts work to prolong a recessionary trend by requiring high contributions when

financial resources are needed elsewhere to effectuate an economic recovery. Additional details on fixing the discount rate and strengthening the funding rules for underfunded plans can be found in our paper on this subject, entitled *Alternatives to the 30-year Treasury rate* (located at [http://www.actuary.org/pdf/pension/rate\\_17july02.pdf](http://www.actuary.org/pdf/pension/rate_17july02.pdf)).

Another issue policymakers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount in accordance with Congress's earlier intentions (something close to a corporate bond rate or annuity pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans (hopefully while the economy recovers). This could mean that fewer plans will need to be trustee'd by the PBGC, and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer-based retirement programs. However, that statement comes with a caveat. Because increasing the interest rate reduces deficit reduction contributions, we need to review the funding and premium rules, particularly if PBGC has further major losses over the next couple of years in this current economic downturn. It may also be appropriate to consider having the general revenue of the United States stand behind the PBGC if it comes under increasing financial stress. This would support the voluntary DB system without fully transferring the obligations of a few troubled industries onto the backs of the vast majority of plans that have worked hard to meet their obligations.

The asset value side of the solvency equation is also currently under debate relative to the risk proposition taken by sponsoring employers and financial economics. The debate over the appropriate mix of assets is part of the prudent-man rules required of trustees to DB plans. However, the debate over asset and liability risk mismatch is currently outside the scope of the law and may only be influenced by the application of an appropriate solvency test and higher obligation by employers for reducing such risks. But the argument made for investment in long-term corporate bonds to match the benefit obligation is juxtaposed with the argument for reduced risk through diversified portfolio theory.

### **Solvency Recommendations**

The replacement benchmark of high-grade, long-term corporate bonds is a reasonable proposal consistent with the intended measurement. However, the period of temporary enactment, as proposed by the administration and others, while the various funding issues are studied should be five-years rather than two or three years. A longer period will provide a higher degree of certainty for employers, allowing them to make longer-term commitments and to develop an appropriate funding policy to fit their business plan.

The drafters of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), that provide for the measurement of funded status and mandated funding escalation, could not have anticipated today's environment. They could not have anticipated the Treasury's decision to stop issuing 30-year bonds nor could the rules have been prudently developed to anticipate a one-in-50 chance of an investment market like the one we've experienced over the past three years. And at the same time the laws represent a complex set of rules

that identify solvency concerns and require higher funding levels. The net result is an increase in funding volatility for companies, many of whom have funded their plans to the maximum allowable by law throughout the 1990s. The combined market conditions place many very well funded plans in a position of having to make dramatically increased contributions immediately or in the near future and respond responsibly to determine the future viability of their plans.

We need a system that is straightforward and predictable. The measurement of solvency should be better grounded with more of a phased-in approach to increasing funding levels. While the gateway events are valuable, the obligation can grow too quickly under the wrong conditions. There could be three types of measures: one that reflects a decline in funded status due to economic changes such as declining interest rates and markets; another reflects a decline due to business practice relating to the sponsor's degree of responsibility for meeting its obligation to fund plan benefits. The third is a measure of the risk a plan is subject to because of provisions like lump sum options, subsidized early retirement, and shut down benefits. Using methods similar to those in evaluating gains and losses for assessing funding experience against assumptions, the source of funded status decline can be determined with different remedies based on the cause. This approach, along with some facts and circumstance provisions for plans that experience extreme changes, will allow companies that can demonstrate their ability to meet long-range obligations the opportunity to apply more gradual contribution increases.

## **Funding**

The funding rules for DB plans need to be overhauled. They are incredibly complex and need simplification. The Pension Practice Council has engaged a task force of leading research actuaries to address the conflicts between minimum funding rules, solvency (in this case to meet the needs assessment of the PBGC) and maximum deductibility rules. However, to effectively utilize the time and expertise of some of the leading actuaries in the country, we need organizations like yours to agree to listen and help bring to light these issues among the policymakers.

The stakeholders for funding are the Internal Revenue Service, participants, and plan sponsors. Funding and tax deductible contributions translate to federal revenue cost. Funding is also a reflection of deferred compensation for employees.

Simplification is necessary to reduce the regulatory cost of DB plans, level the playing field compared to defined contribution programs, and provide a viable system to attract new plan adoption – all critical to meeting the financial security of retiring Americans. For example, there are 11 different amortization periods/rules (including the separate rules for multiemployer plans) for paying off liabilities in the funding rules in IRC Section 412(b) and two more in Section 412(l). The accounting standards only have three rules (working lifetime, retiree lifetime, and period benefits for frequent amendments). In addition, these rules contain disconnects between the payment of benefits and the funding of benefits. They allow employers to improve retiree benefits (which are payable over 10 to 20 years) and pay for the improvement over 30 years, which can hurt a pension plan's funding levels. On the other hand, underfunded plans

must pay off their deficit in three to seven years under IRC Section 412(l), so the amount of required contributions can be very volatile when plans are forced to go from 30-year funding rules to 7-year funding rules. In fact, the volatility was even more dramatic for plans that were prohibited from making deductible contributions in the late 1990s, and now must fund their deficits over seven years (see the attached chart labeled *Current Contribution Rules*).

This problem did not happen when the rules were implemented. In the 1980s, current interest rates were significantly higher, so the full funding limit was much higher than current liability, and the funding rules allowed plans to create surplus margins in their plans. Today, however, the full funding limit can be less than the unfunded current liability for some plans (e.g., hourly plans which cannot project benefits). This makes it difficult for those plan sponsors to create a surplus to get through difficult times. Employers may not have wanted to increase surpluses in the past due to the high reversion tax, but recent experience has taught them the value of having a surplus in their plan. Here are some specific suggestions:

- (a) **Faster Amortization:** The funding rules could be simplified, strengthened, and made less volatile with one change – reduce the number of amortization periods. The funding rules in Section 412(b) could use something less than the 20- and 30-year periods, but more than the 5-year period for experience gains and losses (which causes volatility). Accounting rules already require a shorter period for expensing, so plans may be ready for this change. Unfunded retiree liabilities and frequent benefit improvements could be amortized faster if desired, which would be a simpler and better way to handle mature plans than using a yield curves. This rule would also be closer to the rules for underfunded plans, but some additional smoothing may be needed to phase into them. Faster amortization would also address the concerns that PBGC has with large credit balances eliminating deficit reduction contribution.
- (b) **Greater Deductions in Good Years.** In addition, to provide more flexibility between the minimum and maximum rules, a plan should always be allowed to deduct the normal cost (unless the plan is very overfunded), or enough to avoid a variable premium to the PBGC. One way to do this would be to allow deductions up to, for example, 130 percent of current liabilities, or the full funding limit if greater. Alternatively, the full funding limit could use end-of-year assets (which would enable employers to make contributions to avoid a hit to equity that SFAS 87 might impose).

Contributions are not deductible (and are subject to a 10 percent excise tax) when plan assets exceed maximum tax-deductible limits. Congress has addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability – but even this has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When current interest rates are low, the deductible limit provides little or no margin for adverse fluctuations in assets or liabilities. In many cases, it does not even include liabilities for benefits the plan is committed to provide. Over the past three years, we have seen a significant decline in the funded status of plans – both because the market value of plan investments has fallen, and because liabilities have increased due to lower discount rates.

Thus, we suggest policymakers consider allowing sponsors to deduct contributions until the plan is funded to some higher amount such as 130 percent of current liability (without smoothing). This 30 percent margin would have covered all but two periods in the past 100 years: the Depression years (dramatic decreases in stock prices) and the past three years (dramatic decreases in stock prices and decreases in interest rates). If policymakers want the margin to cover an event like this recent period, then 165 percent would be needed. We recognize the need to balance concerns about pension security with revenue impact; to address this perhaps a lower percentage could be used or the use of 130 percent could be restricted (to plans covered under Title IV of ERISA, for example). Other ways to improve funding are:

- Allow full projection of future benefits. For example, projecting future increases in maximum allowable benefits and compensation limits would be very helpful in improving funding levels for plans where many participants have large benefits (such as pilot plans).
- Allow hourly plans to amortize benefit improvements faster or fund beyond current liability. Otherwise, these plans are always funding benefit increases in arrears, and are always underfunded.
- Recognize lump sums in current liability. Otherwise, plans cannot fund to the benefits that they may actually have to pay.

These ideas and others will be in a paper that we are writing on improving the maximum deductible rules.

(c) **Asset Withdrawals:** Another conflict in the funding rules is caused by the excise tax on reversions. If employers were to contribute a surplus to the plan, and then asset returns exceeded expectations, their pension plans could have more money in them than they would ever need. However, it is difficult for employers to use those surplus funds, unless they terminate the plan (which hurts employees), and pay about 90 percent of the surplus in taxes, which makes it uneconomical. Reversion taxes were implemented in the 1980s to stop corporate raiders from taking the pension surpluses, and some groups still oppose reversions. However, some restrictions could be placed on reversions that might satisfy both parties and avoid the problems of the 1980s, such as:

- Only allow a withdrawal if the assets are unusually high, such as in excess of 150 percent of current liability (or the FFL if greater).



- Set the excise tax so that it offsets the tax advantage the funds received while in the plan. An excise tax under 15 percent could be justified now, due to recent changes lowering tax rates on dividends and capital gains. Or set the excise tax rate to be the only tax charged and set at the highest corporate tax rate regardless of the actual tax rate of the company in the year of reversion to neutralize the potential tax avoidance strategies that might otherwise be engaged.
  - Allow withdrawals only for other employee benefits.
  - Require consent by the collective bargaining unit, if the plan is bargained.
- (d) **Clarify the Laws for Hybrid Plans.** Hybrid plans (e.g., cash balance and pension equity plans) have been around for almost two decades, but the laws and regulations have not been updated to handle these new kinds of retirement plans. Consequently, new rules are being created through court decisions, which try to adapt the old rules to the new plans. Because there has been no clear guidance from Congress to the courts, some employers are falling into traps that did not exist when they set up their plans. A preferred way to handle this problem would be to legislate a solution that applies prospectively. Employers want to follow the rules; they just need to know what they are.

When age discrimination rules were created, they provided different rules for DB and DC plans. Hybrid plans were not on the radar screen. Because they are DB plans that look somewhat like DC plans, it makes sense in certain situations to apply DC rules to them. Without this accommodation, some people have suggested that age discrimination rules prohibit a cash balance plan with the same pay credits for everyone, even if such a plan exactly mimicked a legal DC plan (including investment returns). That does not seem to make good policy sense. On the other hand, a solution to treat hybrid plans as DC plans can create cliffs between traditional DB plans and hybrid DB plans, so another possible solution might be to have one set of rules that apply everywhere. This could make sense, because it can be difficult to distinguish between DB, DC, and hybrid plans. However, cash balance plans that replace a traditional DB plan, may desire to maintain some characteristics from the DB plan, such as the subsidized early retirement benefits from the prior plan, so in certain situations, they will need DB rules.

- (e) **Address the Accounting Policy and Revenue Cost:** Over the years there have been changes to pension funding because there is a significant present revenue cost reflecting employer tax deductions. Actually, the deferred taxable income should be considered in evaluating the potential budget neutrality of legislation that would allow employers to contribute and deduct higher contribution amounts to produce excess reserves against the potential financial business and market risks. In addition, if larger amounts are contributed today, smaller deductions will be needed in the future.

If the budget rules could reflect the additional tax revenue in the future, it would be easier to pass solutions to the pension funding and coverage problems. The budget rules already reflect income beyond the 10<sup>th</sup> year under the Credit Reform Act of 1990 for government loans by offsetting the payments received in the out years for housing loans, school loans, rural electrification loans, the Disaster Loan fund, loans for rural development, the Business Loan Investment Fund, mortgage guarantees, international aid, the Export-Import Bank, foreign military sales, and the Overseas Private Investment Corporation. The reason behind passing the Credit Reform Act was similar to the needs of the DB funding laws: it helped Congress make the best financial decision when deciding whether to provide loans or loan guarantees. This rule change could help Congress make better choices when considering changes to pension law.

### **Recommendation**

The current perceived failure of the funding rules is the result of years of patchwork policy changes and current economic conditions. However, it is these events that require some stopgap changes to help employers retain their plans and at the same time improve on the current system.

Prospective funding requirements must balance the need to fund past service cost over an intergenerationally effective basis and respond to unexpected events. Funding rules should reflect the long-term nature of the contract between the employer and employee without being excessively sensitive to snapshot measurement of assets and liabilities. It should be understood that the value of liability is a tool and not a definitive answer to the full range of the obligation. It is a value taken at a single point in time and subject to change.

Funding measurements should not be confused with financial economics and accounting measurements. The market value of a liability from one year to the next can move significantly but funding based on volatile assumptions creates excessive uncertainty and a degree of unpredictability that could lead employers to prefer a less risky program.

The funding of current and future benefits should reflect the duration of the active workforce and the retired population where appropriate. Similarly, experience gains and losses should reflect the workforce. Complicated assumption mandates, such as the yield curve, should be thoroughly analyzed before implementing because they can add complexity without enhancing the quality of the measurement. Funding rules should continue to be developed on the basis of long-term obligations. In this regard funding methods and asset smoothing methods to allow for more consistent and predictable contribution requirements should not necessarily be abandoned.

If the funding rules are to be overhauled, however, the application of the credit balance and funding standard account should be reviewed carefully. Any review should consider the recommendation for the minimum normal cost obligation, regardless of the credit balance. This would avoid circumstances where a credit balance has been built up in a

fund with significant asset losses resulting in the opportunity to avoid contributions. Ongoing funding requirements will promote funding discipline, potentially, allowing funding holidays only when the funded current liability ratio hits one of the alternative benchmarks discussed above.

As the funding rules are being studied, consideration should also be given to two other areas that could help make DB plans more feasible: addressing pre-tax employee contributions to qualified DB plans, and rules that could enhance the concept of phased retirement by providing in-service distributions.

### **Accounting**

The third perspective is accounting, which should remain outside the scope of legislation. The stakeholders are owners of the company, analysts, and Securities and Exchange Commission (SEC) shareholder lenders. Their focus is to accurately assess the impact the DB plan has on business. Changes in the perspective on how DB plans should be reflected on a corporation's balance sheet have been significant and will likely continue to reflect the emerging view of higher transparency of accounting and measuring the obligation in the near future. There should continue to be a dividing line between the valuation of a DB plan obligation for assessing the financial status of a company and the valuation of the DB as a long-term contract with employees for funding and solvency. It is important the directions taken to address solvency and funding do not get confused with the accounting treatment of DB plans. Techniques such as the use of a bond yield curve can be defended as providing a more accurate value of the liability based on a plan's projected cash flows. This level of spot rate accuracy may be more important in a market assessment environment and may not necessarily provide the type of information for sound long-term decisions when it comes to cash requirements and funding policy.

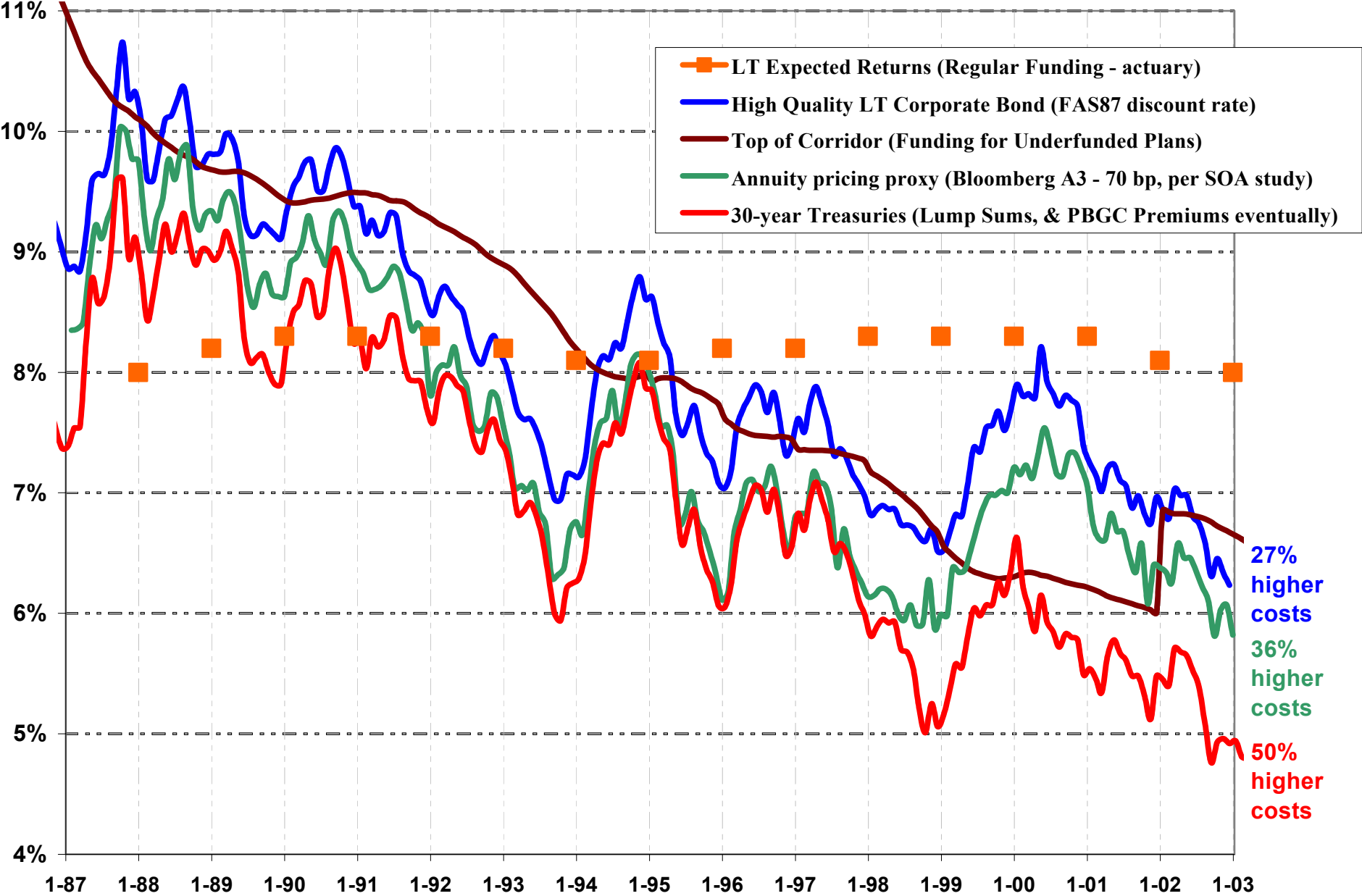
### **Closing**

Defined benefit plans, once the most common form of retirement security for America's workers, have lost much of their attraction for corporations. The investment risks, coupled with complicated solvency rules after three years of low interest rates and market returns have created a funding crisis for DB plans. At the same time, plan participants are starting to appreciate the value of being covered by a DB plan. Employees are beginning to recognize the value of the commitment and insurance element of pooling both investment risk and mortality risk through a company-sponsored plan. As a society, we need to be equally concerned about the significant future number of retirees who may only have defined contribution account balances to rely on to supplement Social Security benefits at retirement. The high risk of personal ruin, through individual self-annuitization is yet to be fully realized.

Strong leadership in support of our voluntary defined benefit retirement system is critical to avoid pushing off the financial burden of a large retired population on future generations. The American Academy of Actuaries and its Pension Practice Council provides expert resources of actuaries who specialize in and lead the practice of pension actuarial valuation. The Academy is dedicated to helping craft a new set of funding rules

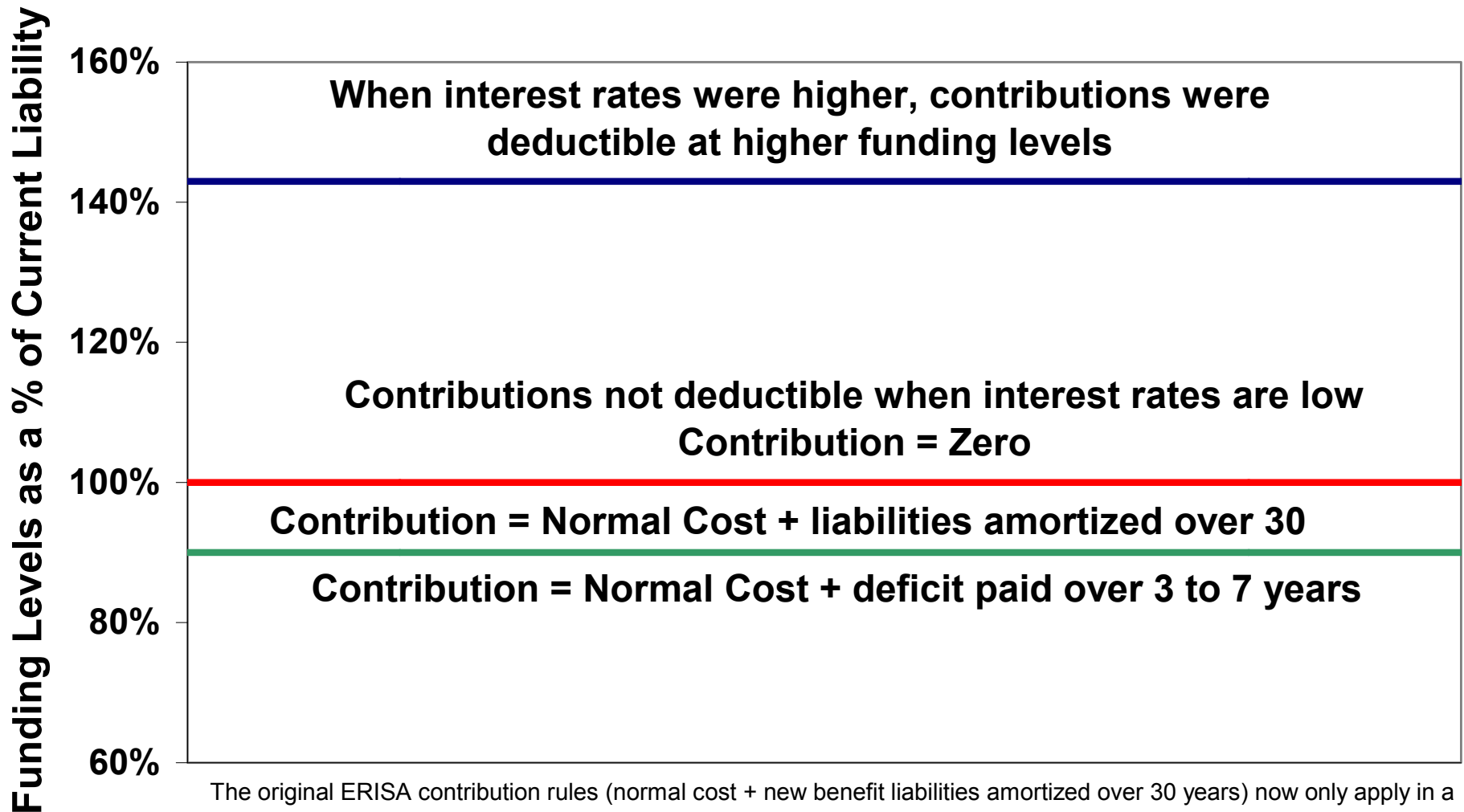
that address the needs of plan constituents going forward. We support the activities of the ERISA Advisory Committee in their study of these issues and are willing, on behalf of the profession, to volunteer our expertise to participate in a comprehensive and lasting solution.

# Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. They produce the costs indicated (relative to LT Expected Returns used for funding), assuming an average pension plan (with duration around 12). The expected returns are from Watson Wyatt surveys.

## Allow Contributions in Good Years



The original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). At one time they applied to all plans. The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).