AMERICAN ACADEMY *of* ACTUARIES

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Committee on Economic and Educational Opportunities
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Hearing on Issues on Pension Reform

Written Testimony Submitted 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 assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to senior federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

The senior pension fellow is the actuarial profession's chief public policy liaison on pension issues. The senior pension fellow represents pension actuaries among federal regulators and legislators by providing nonpartisan assistance on legislative and regulatory questions.

The American Academy of Actuaries commends the subcommittee for addressing the very important issue of how to improve America's private pension system. It is heartening to see the increased national dialogue on providing adequate retirement income security for Americans.

The Retirement Income Dilemma

A series of factors will converge in the coming years to pose a major challenge to the average American's ability to retire with adequate income: the looming retirement of the "baby boom" population; the low savings rate in the United States during the 1980s and 1990s; a decrease in coverage of workers by private defined-benefit pension plans; and the increasing demographic pressures on the U.S. Social Security system. Congress should address these issues now in a comprehensive, coherent policy, or risk that Americans will have inadequate retirement incomes in the future and thus add pressure on the already overburdened social welfare system.

The Current System

As Congress seeks to correct problems within the private pension system, it should be cognizant of the advantages with today's system. The tax incentives contained in the current tax code serve as a primary motivator for employers in setting up and maintaining pension plans for their employees. As a result of employer-provided pension plans, millions of Americans are covered by retirement plans, older workers can retire in an orderly fashion (thus providing job opportunities for younger workers), and dependency on Social Security and welfare programs has been reduced.

The coverage afforded by employer-provided plans is also broad and diverse. In order to receive tax-favored treatment, employers that offer tax-qualified plans must cover virtually all employees. This inclusiveness means broad coverage for lower-paid workers as well as higher-paid ones, older and younger workers, full-time and some part-time workers.

The federal government also benefits from the current system. Because of the broad coverage afforded by private pension plans, fewer people may need federal assistance when they reach retirement. In addition, future generations may not have to be as financially responsible for taking care of their parents. Furthermore, surpluses in America's defined-benefit pension plans (which in many cases were used to pay for early retirement windows and corporate downsizing) could be one of the primary reasons that the United States has become more competitive in international markets.

Of course the present tax system has its negative aspects, such as complexity, double taxation, and myriad tax breaks. Private pension plans have also become a victim of their own success. Given the size of the U.S. federal deficit, the tax advantages afforded pension plans are an attractive means of generating additional revenue for the federal treasury (overlooking the fact that pensions are eventually taxed upon receipt). As a result, recent pension legislation has often been guided by short-term revenue considerations, rather than long-term retirement income needs.

Furthermore, lawmakers have added further layers of complexity to the task of operating a pension plan. To many employers these rules have become so onerous that they have decided to not offer pension plans at all, thus reducing **coverage.** This is unfortunate since a large percentage of U.S. workers are already employed by employers that do not sponsor a retirement plan. These employers are generally small and would rather avoid the complexity and costs of pension plans. (Thus, simplification and tax incentives are obvious choices for a solution to our coverage concerns.) Other employers have sought to reduce their liabilities by adopting less expensive plans, usually defined contribution plans and 401(k) plans, that place a greater responsibility on the employee to help save for retirement. Thus, **pension adequacy** is also a major concern. Studies by a number of actuarial consulting firms have compared investment returns for traditional pension plans—in which the employer assumes the investment risk—to returns on plans in which individuals take the risk. Traditional plans outperform individual plans by 150 to 250 basis points each year. Such differences can have a great impact on benefits. For example, a 200-basis-point difference for a 35-year-old would translate into a 50% smaller pension beginning at age 65.

Pension Simplification

In recent years, Congress has sought to address the growing complexity of operating a pension plan through a series of pension simplification proposals. The Academy welcomes many of the pension simplification provisions—such as streamlining the definition of highly compensated employee and repealing the combined plan limit and family aggregation rules.

Pension simplification is an important first step toward strengthening Americans' retirement income security, however, it is only a first step. Even if the current proposals were to be adopted in full, there would still be a clear need to further ease the compliance burden.

Criteria for Reform

The Academy strongly urges Congress to develop additional pension legislation that falls within the framework of a comprehensive national retirement income policy, rather than a piecemeal approach that is driven by short-term revenue considerations. Attached to this testimony is the Academy's "Criteria for Retirement Plan Legislation and Regulation." The Academy urges elected officials to consult these guidelines when developing pension reform legislation. Among the guidelines Congress could follow:

X Pension legislation should be developed in the context of a national retirement income policy, including Social Security.

X Pension legislation should encourage the formation and growth of both defined benefit and defined-contribution plans. Neither plan should be placed at a disadvantage to the other.

- X Pension legislation should not be driven by short-term revenue considerations.

- X Changes in pension law should be made as infrequently as possible.

Ideas for Reform

The Academy's Pension Committee is compiling a list of proposals, not necessarily endorsed by the Academy but put forth by the pension community, that could move toward a national retirement income policy and encourage employers to provide adequate pensions for their employees. While not yet complete, some of the ideas follow.

- X Pension rules have become much too complex, and employers are discouraged by administrative burdens that accompany management of their plans. Simplifying the non-discrimination, funding, and distribution rules, which have become incredibly complex, could stop the trend away from defined benefit plans. The Academy would be very interested in assisting you on this issue.

- X Simplify the coverage and nondiscrimination rules for 401(k) plans. For example, eliminate the three ADP (actual deferred percentage) and three ACP (actual contribution percentage) rules and their complex interaction, and replace them with one rule: the average rate of contributions from highly compensated employees (HCE) cannot exceed 150% of the average contribution rate of non-HCEs.

- X Simplify 401(k) coverage, distribution, and nondiscrimination rules for employers that maintain a minimum non-integrated defined-benefit plan covering all employees.

- X Eliminate the §401(a)(4) nondiscrimination rules and replace with a perfected and simplified §401(l).

X Repeal top-heavy rules, because subsequent rules have made them unnecessary.

X Allow pre-tax employee contributions to defined-benefit plans up to the 402(g) limit.

X Simplify the funding rules for poorly funded plans to require funding of retiree liability over five years and the remaining unfunded liability over ten years. Allow projection of IRS limits for funding purposes.

X Instead of the multiple, mandated valuation bases used for reporting and disclosure, variable PBGC premiums, current liability, amortizing waivers, etc., there should be only one. If they were all based on termination liability (tightly defined) and regulated through actuarial standards, then no mandatory assumptions would be required, thus greatly simplifying the law and allowing enough flexibility to handle all non-standard situations.

X Instead of continually mandating additional pension rules with mandatory effective dates (and late regulations), Congress could use safe harbors and incentives to encourage employers to move in the right directions. If incentives or safe harbors were used, employers could decide *if and when* they would comply with the new laws. An example of this is the current rule to reduce the excise tax upon reversion, if a replacement plan is established for employees. Another example would be to encourage employers to make pensions more portable by giving them inflation protection upon plan termination in exchange for a lower excise tax rate. A recent bill (S.1922) proposed by Senators Bingaman and Jeffords uses incentives to promote a minimum non-integrated defined-contribution plan.

- X Some distribution rules could be relaxed for plans that add an optional form providing for a inflation-indexed annuity.

- X Decrease the PBGC's per-person premium, now that the PBGC is more secure, or allow the PBGC to make downward adjustments to premiums.

- X Create a private sector Board of Actuaries to assist the PBGC (similar to those at the Office of Personnel Management and Department of Defense).

- X Charge PBGC variable premiums for shutdown benefits and other subsidized early-retirement benefits.

- X Complex PBGC laws regarding benefit guarantees and asset allocations need to be rethought and simplified. Currently, retirees with benefits over $100,000 per year can be fully paid by the PBGC while younger employees in the same plan can lose disability benefits, contingent benefits, supplements, and some of their vested benefits (even though they might be only $1,000 per year). For example, limit Priority Category 3 to one or two times the PBGC maximum benefit and guarantee some of the above benefits.

- X Simplifying the above PBGC laws (including the allocation of PBGC recoveries in bankruptcy) could enable final PBGC benefits to be paid more timely.

- X Freeze PBGC maximum guarantees.

- X Eliminate the PBGC's five-year phase-in in favor of a three-year cliff guarantee.

- X Financial assistance rules under MEPPA (Multi-Employer Pension Plan Amendments) could be applied to single employers in Chapter 11 reorganization and might be a better alternative than the PBGC having to take over their whole pension plan.

- X Eliminate Section 415 maximum-benefit rules, since Section 4980 excise tax handles the same issue and it raises revenue.
- X Encourage the IRS to use negotiated-rulemaking ideas similar to the PBGC.
- X Encourage simplified pension plan documents (using Flesch tests) by allowing elimination of summary plan descriptions in such cases.
- X Eliminate summary annual reports, because they are rarely read.
- X Allow use of certified office E-mail for reporting and disclosure to active employees.
- X Prohibit lump sum withdrawals from pension plans prior to retirement. This could also be done by an increase in the excise tax on premature withdrawals or mandating their rollover.
- X Combine IRS, the Pension Welfare Benefits Administration (PWBA) at the Department of Labor, and PBGC into one federal pension agency that is less likely to create conflicting rules.
- X Abolish simplified employee plans (SEPs), which have been prone to abuse. They wouldn't be needed if laws were less complex.

This list is just a small sample from our paper and we must reiterate that the Academy has not taken a position on any of them. We will provide you with a copy of the report when it is completed.

Conclusion

The Academy believes that the current environment for private pension plans needs to be examined, not only to encourage the formation of new plans, but also to alleviate some of the burdens that employers face trying to maintain their plans.

We have outlined some suggestions, and we would be eager to discuss their policy implications with you in the future. The Academy is pleased that Congress and the public are beginning to recognize the serious challenges that will face America's retirees in the near future. We believe these challenges are better met today when the problem is manageable, rather than tomorrow when the political and policy obstacles could be much greater.