



AMERICAN ACADEMY *of* ACTUARIES

**Testimony of
Ron Gebhardtsbauer, MAAA, EA, FCA, FSA
Senior Pension Fellow
American Academy of Actuaries**

**Before the
Subcommittee on Retirement Security and Aging
Committee on Health, Education, Labor and Pensions
United States Senate**

**Hearing on
PBGC Reform: Mending the Pension Safety Net**

April 26, 2005

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.

An Analysis of the Administration's Single Employer Pension Funding Proposal

Thank you, Chairman DeWine and ranking member Mikulski, for inviting me to testify on reform of the Pension Benefit Guaranty Corporation (PBGC), as well as other aspects of the Administration's single-employer pension funding reform proposal.

The Pension Practice Council of the American Academy of Actuaries believes that a healthy defined benefit (DB) system is essential to the financial security of our nation's retirees. The financial status of the PBGC is one of a number of crucial elements that needs to be addressed as part of a larger focus on pension reform. Within the context of the following analysis of the administration's funding reform proposal, we address many of the issues relevant to this hearing.

The administration's recent proposal reflects many of the funding reform principles discussed in our paper, *Pension Funding Reform for Single Employer Plans*;¹ namely: solvency, predictability, transparency, incentives for funding, flexibility, avoidance of moral hazards, and simplicity. In particular, their proposed use of one funding rule and one amortization period improves transparency and simplicity. Flexibility is enhanced by their provision to increase the maximum deductible contribution. In addition, they eliminate rules that currently allow sponsors of underfunded plans to avoid paying contributions and variable premiums.

However, the proposal may cause employers to decide their only viable alternative is to freeze and/or terminate their pension plan due to concerns that their minimum required pension contributions could become too volatile and unpredictable.² Plan terminations would have negative repercussions for national retirement security, the markets, employee morale, the PBGC,³ and an employer's ability to manage its workforce. This outcome can be avoided. In this statement, we identify how some of these concerns can be addressed to ensure a strong pension system.

Solvency

Funding targets: The administration's proposal sets a funding target of 100 percent of accrued benefits and increases the funding target if the credit rating of the plan sponsor falls below investment grade status. However, the additional funding to the administration's "at-risk" liability may be too late, because a company may already be too weak to make the additional contributions. Unfortunately, healthy companies may balk at funding to the higher "at-risk" liability because the additional funds may never be needed, nor could they be accessed without paying prohibitive taxes of over 90 percent.

Funding margins: Rather than creating a different structure of liability calculations for companies with low credit ratings, Congress could devise a set of funding rules that naturally lead toward the creation of a funding margin. For example, once the funding level exceeds the initial target liability, a minimum contribution (e.g., the normal cost) could be required until assets reach the "at-risk" liability or the accrued liability with salary projection (as in current law). This would create funding margins, which are what kept traditional salaried plans so much better funded than hourly plans in the past; encourage funding discipline; and avoid the need for ratings. Alternatively, the normal cost could be phased out by \$1 for every \$5 of surplus instead of for every \$1 of surplus

¹ This paper can be found at http://www.actuary.org/pdf/pension/funding_single.pdf

² The administration's use of one funding rule eliminates the DRC funding cliff, which is good, but it would increase volatility anyway due to requiring the use of market assets and only 90-day averaging of market interest rates. For example, equities declined by 33 percent in October of 1987. That could have doubled an employer's minimum contribution. In addition, if only 90-day averaging were in use in 1982 and 1986, the interest rate would have decreased by about 300 basis points in those two years, which could have more than doubled an employer's minimum contribution. Some employers might decide to move more of their plan assets into bonds (to dampen the volatility of the plan's underfunding and thus the minimum contribution). However, surveys suggest that many employers have concerns that their contributions would increase too much due to lower expected returns on bonds, and that their employees would rather take their chances investing in the stock market in a defined contribution (DC) plan. Another option would be for employers to fund their plan more to create a funding margin (which could help employers avoid volatile minimum contributions), but this may not be widely adopted unless Congress relaxes the rules regarding access to surplus assets.

³ The PBGC could lose their healthy premium payers, but not the weak employers with underfunded plans, because the latter would not be able to fund enough to unilaterally terminate the plan under applicable rules. In addition, under the administration's funding proposal, weak employers may still invest large percentages in equities but not build up funding margins to protect the plan from equity declines.

as in the administration proposal. This would also build a funding margin and help the employer avoid volatile minimum contributions.

At-risk liability: The administration's proposal determines the funding target for weak companies using an assumption that all employees will retire as soon as possible.⁴ However, this may not represent the most valuable benefit. For example, in many pension plans, the earliest possible benefit is payable at age 55, while a much more subsidized retirement benefit may be payable at the employee's 30th year of service, which might occur at a later age. If this subsidized benefit occurs soon after age 55, the employee may very likely delay retirement in order to get the subsidy. Fortunately, the administration proposal would require the use of the actuary's best estimate of the liability, if it is greater than the prescribed liability. This may solve the problem of potentially undervaluing the at-risk liability.

Assumption setting: History has shown that using the law and regulations to specify actuarial assumptions has not been successful, as evidenced by the delays in setting the discount assumption and the continuing debate on replacing the currently required 1983GAM mortality table. We recommend that the law allow actuaries to set the mortality assumption, since it differs by plan. The law and actuarial standards both now require each assumption to be individually reasonable, which is a major change from when Congress first started specifying assumptions. If there are concerns, then actuaries could be required to justify their assumptions in writing if they seem out of the ordinary.

Valuation dates: We do not understand why the administration's restriction on valuation dates needs to be imposed. If anything, it is hoped that more plans could use prior year valuation data⁵ (along with year-end market assets), in order for companies and associations to budget in advance for their contributions and to disclose funded status information to participants in a more timely manner.

Predictability and Hedgeability

The administration's 90-day smoothing provision will cause problems for both sponsors of bond-immunized pension plans as well as sponsors of diversified stock portfolios. For the immunization sponsors, the 90-day smoothing provision will make it difficult for plans to hedge their liabilities, since bond prices will not rise and fall with liabilities using a smoothed discount rate. (They should be allowed to use market liabilities, just as they can now elect to use market assets.) For the diversified stock portfolio sponsors, 90 days does not provide enough smoothing to make contributions predictable. Their contributions will be volatile (and vary greatly depending on the date valued), unless there is some mechanism to reduce the volatility.

Contribution volatility: We suggested the creation of an anti-volatility mechanism (AVM) in the predictability section of our funding reform paper. It would place a cap on large increases in the minimum contribution, such as 25 percent of the normal cost, or 2 percent of the plan's accrued liability, if greater. It would enable faster elimination of underfunding than one might first surmise, because the effect is cumulative. Our analysis shows that the cap would rarely be applied more than three years in a row, and that assets could reach the funding target as quickly as the administration's proposal if desired. Other ways to reduce volatility would be to average funding ratios or smooth assets and liabilities.⁶

Reduce cyclical nature of minimum contributions with credit balance: Minimum contributions can be large in difficult times and small (or zero) in good times, which is very hard on employers and exacerbates the cyclical nature of our country's economy. Credit balances can fix this problem by encouraging employers to contribute more in good times, knowing that the excess contribution will enable them to contribute less in difficult times.

⁴ They also add a loading factor to reflect the cost of purchasing a group annuity, even where a significant portion of the liability may reflect lump-sum payments.

⁵ Liabilities a year later could be determined by adjustments for the accrual of benefits, the passage of time, and changes in interest rates and significant events, as is done when utilizing the alternative method for determining PBGC variable premiums.

⁶ Smoothing interest rates over 2 years may not be adequate. For example, in 1986, a two-year weighted average of interest rates would have been just as volatile as the market interest rates, and the one-year average would have been more volatile (i.e., the one-year average changed by 350 basis points from January 1986 to January 1987).

Eliminating the credit balance would create a powerful disincentive for companies to contribute anything more than the minimum required contribution. For example, if they leave the money on the outside of the plan they get dollar-for-dollar credit for it when they use it to pay the minimum contribution in the following year. However, if they contribute it to the pension plan, they may not get any credit for it the next year because the amortization rules in the administration proposal are so one-sided. At most they would only get 1/7th of the credit. Thus, there would be a tremendous reluctance to take a chance on contributing an additional amount to the plan, if plan sponsors knew that they might need that cash to pay next year's contribution.

Some of the objections to the use of credit balances could be overcome by growing credit balances at the same rate that plan assets grow, instead of at the valuation rate. The other objection is that credit balances allowed several sponsors of distress-terminated plans to avoid contributions right before their plans terminated with insufficient funds to pay all benefits. However, with the above fix, the credit balance provision would only increase the assets in the plan. Taking advantage of a credit balance would only return plan assets back to where they would have been had the employer never contributed more than the minimum. Thus, the objective should be to make sure the minimum funding rules are strong enough, not eliminate the credit balance.

If there is still a concern that credit balances can eliminate contributions to underfunded plans, then a compromise rule could prohibit using the credit balance from offsetting the full contribution when a plan is underfunded. The underfunded plan could be required to pay the normal cost, unless it gets a waiver from the IRS, provides security, or freezes accruals.

Volatile plan design: The administration's abrupt freezing and unfreezing of benefit accruals will make plan administration and employee notification very difficult, disrupt employee expectations, and call on actuaries to estimate liabilities before employee data is available.⁷ This problem is exacerbated by having to freeze benefits for certain plans if the actuarial valuation is not completed by a specified time — even if there is nothing in the plan's demographics or assets to indicate that the funding status has deteriorated since the prior valuation.

A remedy to this problem could be to require an accrual freeze only if the funding ratio is less than the threshold for two consecutive valuation dates, and to allow employers to cure the problem by a contribution or security after the first valuation showing a deficiency. Similar rules could also be provided for:

- the Internal Revenue Code (IRC) Sec. 401(a)(29) threshold requiring security for amendments;
- the 100 percent threshold for IRC Sec. 412(m) quarterlies and for having to pay the variable rate premium;
- the 125 percent threshold for IRC Sec. 420 transfers to retiree health plans; and
- the thresholds in IRC Sec. 412(c)(9)(B) which allows use of a prior valuation.

Congress should consider freezing benefits in all plans under the threshold (60 percent in the administration's plan), not just those of weak employers. This would encourage healthy employers to fund their plans when they can, and it avoids the need for the government to rate companies.

Eliminating lump sums will also disrupt employee expectations, and could easily cause a "run on the bank," which not only hurts the PBGC, but also the workers and retirees remaining in the plan. Ways to avoid this problem include:

- Increase the threshold for prohibiting lump sums to 100 percent of target liability (or more). There is less concern about a "run on the bank" in paying a lump sum when a plan is over-funded. Note: the current rules in the Code of Federal Regulations (CFR) 1.401(a)(4)-5(b)(3) already restrict lump sums for highly compensated employees (HCEs) or the top 25 when funding ratios are less than 110 percent. They could be applied to all HCEs.
- Keep the plan well funded, or require the plan sponsor to contribute the unfunded portion of the lump sum, in addition to the minimum contribution.

⁷ The Administration proposal requires actuaries to certify that the funded status of a plan exceeds a certain threshold within three months after the beginning of the plan year, in order to stop an accrual freeze. Typically the actuarial valuation is not complete by then, nor does the actuary have the data. If actual data later shows the plan is even more poorly funded, the retroactive effects on participants could be a cause for concern.

- Phase in the lump-sum ban by only allowing payment of the funded portion of the lump sum. For example, if the plan is 90 percent funded, pay 90 percent of the lump sum.
- Allow or require sponsors to eliminate the lump-sum provision without violating IRC Sec. 411(d)(6), as long as it is replaced by a 20-year certain and life annuity. (And allow insurance companies to pay the lump-sum value if the annuitant signs over the pension to the insurer).

Outlawing shutdown benefits in their entirety (as proposed by the administration) may not be necessary in cases where the plan's funding is adequate and/or plan sponsor can cover the increased benefits. These contingent benefits have been responsible for some of the most dramatic losses absorbed by the PBGC and present considerable funding challenges. However, they have also proved to be valuable to employees and a valuable tool for workforce management in many circumstances.

Congress could consider a proposal that would allow a plan sponsor the option of eliminating these benefits without violating IRC Sec. 411(d)(6). For those employers who wish to retain these benefits, perhaps the following could be considered:

- Retain the ability to provide these benefits if the plan is well enough funded to cover the incremental benefits.
- Treat the shutdown benefits as an ad hoc amendment, similar to an early retirement window, that would phase in PBGC guarantees from the date of the shutdown and trigger the proposed funding requirements. Under this scenario, incremental shutdown benefits would not be payable if the employer could not make the additional contributions required under the proposed rules.
- Increase the variable premium to reflect the liabilities that would be created by these benefits.

Transparency

Disclosure: We agree with the administration's proposal to require more timely and meaningful disclosure of trends in funding ratios, and in fact, would go further. We would require year-end disclosure for all plans. We would also suggest requiring a breakdown of plan assets by equities, bonds (long, medium, short, and government vs. corporate), and other assets to help participants project funding ratios from the most recent information. This is already required on an aggregated-plan basis for financial statement disclosure, so this should not require much additional effort for plan sponsors. However, we would not require disclosure of the at-risk liability for plans of healthy sponsors, since it would not be relevant and could mislead participants.

Earlier Schedule B actuarial information: The administration's proposal would require the Schedule B earlier for plans with more than 100 participants. As noted above, we would include year-end asset information and estimates of year-end liabilities, since similar calculations are already performed for accounting statements and variable premiums (using estimates for significant events). We would also suggest applying this disclosure rule to all plans, regardless of size, as long as estimates can be used. However, we would not require information on the funding standard account until the final contributions are made, which can be up to 8 ½ months after the end of the plan year.

PBGC guarantees: We would also suggest simplifying PBGC guarantees (as discussed in the transparency section of our funding reform paper) so that the Employee Retirement Income Security Act (ERISA) Sec. 4011 notice to employees, which discloses benefits that would be lost if their pension plan terminated in distress, is more understandable.

Incentives to Fund; Flexibility

Expanding asset transfer rules: Increasing deductible amounts as provided in the Administration proposal will help us have better funded plans after market declines.^{8 9} However, it will not work unless employers can access a

⁸ In 2002, many plans could not deduct their unfunded ABO at year-end, even though they wanted to. The administration's proposal can be very helpful here.

⁹ The administration might consider increasing the maximum deduction to 150 percent of their target liabilities (which are based on corporate bond rates), since the current rules allow deductions using 90 percent of Treasury rates. However, this idea would have to be balanced with revenue concerns. We also

plan's super surplus (above a high threshold) to use for other purposes, such as other employee benefits. Otherwise, employers will be reluctant to take a chance on contributing additional amounts that may later be inaccessible. While some employee advocates have concerns about this issue, we think it can be constructed in a tight enough way to benefit the employees, while at the same time addressing the concern that the pension plan could be insufficient someday. See the discussion on this in our funding reform paper.

Retain credit balance provisions: The credit balance provisions provide incentives to employers to contribute more in good years. (See the earlier discussion on reducing the cyclical nature of minimum contributions with credit balance.) In addition, plan sponsors who accumulated credit balances in good faith under the current rules with the expectation that they were building a cushion for use in future years should not lose that promise.

The administration's proposal to preclude funding of nonqualified deferred compensation (unless the employee pension plan is similarly funded) is an attempt to encourage sponsors to fund the employee plan. However, we don't think it will work, in part because amounts funded for nonqualified deferred plans are already subject to creditors' claims and would generally be forfeited if the qualified plan fails. A real incentive would be to securitize a mirror nonqualified plan to the extent the employee qualified plan is funded, as discussed in the incentives to fund section of our funding reform paper.

Avoid Moral Hazards

Risk-related premiums: The administration's proposal changed the rules for determining the risk-related premium by requiring the earliest retirement age assumption for weak companies, and by using the same discount rate as for funding. In addition, the full funding limit (FFL) exemption is gone, so employers will not be able to avoid paying a variable premium as in the past — unless they are 100 percent funded.

However, we are concerned that the administration's proposal lets the PBGC board set the premium rate and funding policy without limits, and without any input from its premium payers. For example, the PBGC board could decide to set the premium at an amount that would require the remaining DB plans to quickly pay for all of the PBGC's past underfunding. This would require a premium that is greater than is actuarially required from the remaining plans that have not abused the PBGC. Since Congress has never clearly stated whether the PBGC should be funded like an insurance company, a pension plan, or a pay-as-you-go government agency, this rule puts that decision in the hands of the Board without any input from Congress. At a minimum, Congress should set limits on how large the premium increases can be and how well PBGC should be funded. In addition, we note that it is better for Congress to tighten the funding rules than for the PBGC to increase premiums.

PBGC could avoid some distress terminations: The administration's proposal freezes benefits and PBGC guarantees when employers enter bankruptcy. With these powers, the PBGC's losses are limited. We suggest, therefore, that the PBGC could be given the authority to work out pension financing deals with employers, without having to threaten plan termination --- its only recourse under current law. This will be especially important if PBGC cannot get (1) higher priority in bankruptcy for its missed contribution claims or (2) the ability to perfect its liens against companies in bankruptcy.

Simplicity

Yield curve: The administration's proposal generally provides simpler rules. One exception is their requirement to use a corporate bond yield curve. While we appreciate the theoretical value of using a yield curve and could adjust our models to incorporate this, a cost-benefit analysis will show that, in practice, the yield curve complicates valuation and lump-sum calculations without adding meaningful accuracy.

suggest that the administration consider repealing the combined plan limit. At a minimum, it should use 130 percent (or 150 percent) of liabilities to conform with the administration's revised rule for DB plans, and it should eliminate the excise tax for non-deductible contributions, since the reversion excise tax is sufficient for employers to not make excess contributions. See these and other ideas in our paper on maximum contributions found at http://www.actuary.org/pdf/pension/deduct_letter_051404.pdf.

For example, using a yield curve will not change the liability, except on a very mature plan during the few times when the yield curve is steep. And it will change the liability by only a small amount (e.g., 3 percent, which would only increase liabilities from \$10 million to \$10.3 million). At the same time it will decrease the liability for a very young plan, so it may not increase the PBGC's variable premium income by much at all. Furthermore, requiring more accuracy for the discount rate, while prohibiting more accuracy on the mortality table, is not consistent. It is interesting to note that using collar mortality differentials would be enough to undo the small differences created by using yield curves. Thus, Congress should give regulators the ability to simplify the yield curve calculations, if they find it less valuable than initially thought. Note that the PBGC itself originally used a yield curve for multi-employer calculations, but replaced it with the simplified method they use for single employer plans.

Furthermore, the yield curve won't work for the portion of a plan's assets invested in Treasury bonds. Recent experience has shown that Treasury bond prices can increase when corporate bond prices decrease, and vice versa.

In addition, although the proposal phases in the financial effect of the yield curve over a three-year period, it requires that actuarial valuation systems be revised to accommodate these calculations in time for the 2006 valuation. We suggest that, at a minimum, a simplified yield curve be adopted, something similar to the interest rate structure used by the PBGC. This part of the proposed changes should be delayed to allow for the required reprogramming.

Transition

Three-year transition: The administration's proposal has a three-year transition period, which may not be sufficient time for contribution volatility concerns, especially if the credit balance provision is eliminated. In addition, if the administration's proposal is adopted without modification, financial observers suggest the need for a longer transition to allow financial markets to adapt to a potential shift in pension asset allocations between stocks and bonds. The bond market, in particular, will need more time for issuers to supply pension plans with the long-dated instruments needed to better match assets to liabilities, without driving interest rates down and exacerbating the problem. A longer transition would be less disruptive. Our anti-volatility mechanism (AVM) could also assist in providing a better transition.

Encourage DB Plans

We applaud the administration's proposal for clarifying the age discrimination and whipsaw issues for hybrid plans. However, the administration's proposal also reaffirms its earlier savings account ideas, requires a five-year maintenance rule for DB plans converting to cash balance plans, and doesn't resolve retroactivity concerns for prior conversions. These three concerns could cause the widespread elimination of all DB plans by further making it easier to sponsor a defined contribution plan than a DB plan. By continuing to propose changes that undermine the formation and maintenance of traditional DB plans the administration's proposal could seriously harm DB plans, even though DB plans provide vast financial value and benefits to individuals, employers, the markets, and the nation. We suggest that DB plans need equal treatment with 401(k) arrangements.

At one time policy favored DB plans because (1) they were more likely to provide a lifetime income and (2) they cover almost all employees. With lower tax rates for capital gains and stock dividends, the equilibrium for deciding whether to sponsor a DB or DC plan with all its associated coverage requirements and complex rules, versus just providing cash to employees, has been greatly harmed. We recommend that Congress return its historic tax advantage to retirement plans by taxing pension distributions at the same rates.

Summary

The administration proposes many valuable changes. For Congress to strengthen national retirement security, they must provide an environment that encourages employers to keep their DB plans and pay premiums to PBGC. At a minimum, reform should include:

- controlling the volatility of contributions (by, for example, using the anti-volatility mechanism);
- retaining the credit balance concept (with modifications) to reduce the cyclical nature of minimum contributions and provide incentives for employers to make contributions in good years; and
- allowing employers to access super surpluses for other uses, such as other employee benefits, as an incentive for employers to contribute more in good years.

At the American Academy of Actuaries, we are dedicated to applying our understanding of DB plans to working with the administration and Congress to shape a strong system of financial security for our nation's retirees.