PROMISES TO KEEP: THE TRUE NATURE OF THE RISKS TO THE DEFINED BENEFIT PENSION SYSTEM

A Report Prepared for the American Benefits Council

OPTIMAL BENEFIT STRATEGIES, LLC

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EXECUTIVE SUMMARY

Defined benefit pension plans face a critical juncture

- Single employer-provided defined benefit pension plans have long been a key component of adequate retirement savings for millions of American workers. Yet these plans face a critical juncture. The response of policymakers to the daily news reports about problems facing the defined benefit plan system will determine whether a healthy and viable system emerges. How accurate are the reports about the problems facing defined benefit plans and the Pension Benefit Guaranty Corporation (PBGC), which insures the benefits under these plans? Evidence suggests that the problem, while troubling and in need of a legislative solution, does not merit the panic that the stories attempt to generate.

> ***Our estimates indicate that, using slightly more reasonable assumptions, the PBGC's deficit could be reduced to $14.3 billion and, under one scenario, could be as low as $4.6 billion.***

- Because employers enter the defined benefit pension plan system voluntarily, policymakers need to be sensitive to the possibility that certain legislative responses will drive more employers (including employers with well-funded plans) to exit the system. Predictability of funding obligations is the single most important issue for employers; legislation that increases the volatility and unpredictability of funding requirements will undoubtedly lead to increasing plan terminations and freezes.

PBGC's deficit calculations overstate the problem

- At the end of 2004, the PBGC estimated that its deficit was $23.3 billion. While this number seems large, it represents only a tiny (less than 1 percent) share of the more than $1 trillion of total assets in defined benefit pension plans. Furthermore, the interest rate assumptions used to calculate this deficit are unacceptably low, thereby inflating the deficit figure. Our estimates indicate that, using slightly more reasonable assumptions, this deficit could be reduced to $14.3 billion (and, under one scenario, could be as low as $4.6 billion).

- Many people inappropriately liken the situation with the PBGC to the savings and loan crisis of the late 1980's. The PBGC's obligations do not arise from demand deposits. Any liabilities it incurs from terminated defined benefit plans give rise to long-term liabilities. The PBGC does <u>not</u> have a current solvency crisis. By any reasonable measure, the PBGC has sufficient assets to continue paying benefits for at least 15 to 20 years.

The majority of defined benefit pension plans are not at risk

- The vast majority of the 34 million workers and retirees who are covered by single employer defined benefit pension plans need not worry about the security of their benefits because they participate in well-funded plans and there is no serious threat of default. On the other hand, some plans have significant underfunding and a legislative response is clearly needed to address the problem.

- Much of the deterioration in the funded status of defined benefit pension plans occurred in the last four years as a result of a weak economic environment in certain industries. While additional high-profile plan terminations are likely, recent evidence suggests that overall, there has been some rebounding in the funded status of defined benefit plans in general.

PBGC's investment strategy is flawed

- The PBGC's strategy for investing its assets is flawed by being overly conservative. It is far more conservative than the prudent and diversified investment practices of most private plans that are adequately funded. Indeed, it is even far more conservative than the Administration's own proposal to partially fund Social Security through personal accounts. A more reasonable investment strategy (with a change in the law to permit premium income to be invested in assets other than low-yielding Treasury securities) would improve the rates of return on assets and reduce its deficit.

The PBGC does* not *have a current solvency crisis. By any reasonable measure, the PBGC has sufficient assets to continue paying benefits for at least 15 to 20 years.

Inappropriately low interest rate assumptions hurt the defined benefit plan system

- Unrealistically low interest rate assumptions exaggerate the underfunding in defined benefit plans, which hurts plan participants and sponsors in a number of ways: (1) the benefits plan participants receive may be reduced on plan termination; (2) extraordinary contribution requirements (and variable rate premiums) may be triggered, putting additional pressure on cash-strapped companies; and (3) companies' credit ratings may be inappropriately and adversely affected.

- Unrealistically low interest rate assumptions can also overvalue lump-sum distributions relative to annuities. This overvaluation can lead to systematic underfunding of defined benefit pensions plans and a distortion in the choice of retirement income.

I. INTRODUCTION

Pension funding is not a sexy subject, so it is significant when Congress gets serious about reforming the rules by which defined benefit pension plans are funded. Legislation is needed this year to replace temporary provisions enacted in 2004 that fix the "broken" interest rate plans were required to use when calculating future pension liabilities.

Much of the drive to reform the nation's single employer defined benefit plan system is traced to the increased deficit of the PBGC, the federal insurer of 34 million U.S. workers' pension benefits.[1] Last year the PBGC calculated that its deficit more than doubled, to $23.3 billion, the largest in the history of the agency. Coupled with this, some recent and high-profile plan terminations rang alarm bells as to the financial soundness of the entire defined benefit plan infrastructure.

A seemingly arcane issue, relating to the correct interest rate to use in valuing pension obligations, is also at the core of the PBGC's recent deficit surge: the agency uses an interest rate that many believe is too low, inflating the perceived shortfall by billions of dollars. Because pension promises come due over the course of many years, a low interest rate means more money needs to be set aside today to meet these obligations. Our own calculations suggest that the use of a more generally accepted interest rate – for example, the rate on investment-grade corporate bonds – would reduce the PBGC deficit to $14.3 billion.

The PBGC uses an interest rate that many believe is too low, inflating the perceived shortfall by billions of dollars.

1 Approximately 10 million workers are also covered under the multi-employer pension plan system. Pension Benefit Guaranty Corporation 2004 Annual Report, p. 86.

For workers currently covered by defined benefit plans, the interest rate assumptions matter. As described in more detail later in this paper, low interest rates can have the following adverse affects:

- Healthy plans are made to look worse than they really are.
- Plan sponsors may be forced to freeze plan benefits or even drop well-funded plans.
- When the PBGC takes over a terminated plan, some retirees will get their benefits reduced unnecessarily.
- Lump-sum distributions are overvalued relative to annuities.
- Overinflated estimates of future liabilities may result in legislative solutions that go too far and end up killing a system that has been the basis for retirement income security for millions of American workers.

No one suggests that the PBGC has a solvency crisis imminently looming. In fact, the agency has enough assets on hand to pay benefits for the next 15 to 20 years. Similarly, no one denies the need for pension funding reform to improve and strengthen the funding of defined benefit pension plans. However, as legislation moves forward, a closer look at the facts is warranted.

In this report, we address three fundamental questions:
- Just how bad is the PBGC's current funding situation?
- Why should workers care?
- What legislative proposals are critical to the long-term survival of the defined benefit system?

II. HOW BAD IS THE PBGC'S SITUATION?

According to its 2004 annual report, the PBGC had $39.0 billion in assets on hand to pay an estimated $62.3 billion in future claims. The resulting $23.3 billion operating deficit was the largest in the agency's history; more than double in size from that reported in the previous year. The following factors contributed to this apparent deterioration in its funded status:

- Investment performance. Like most pension funds, the PBGC was hurt by falling stock prices and declining interest rates beginning in 2000.
- Recent terminations. The agency recently took over the liabilities of several large plans, most notably in the airline industry.
- Change in mortality assumptions. The PBGC made a one-time adjustment to mortality assumptions in 2004 that increased its losses.

Low Interest Rate Assumptions Inflate PBGC's Deficit

One factor has contributed more than any other to inflate the size of the PBGC deficit: an interest rate of less than 5 percent used to value its own future pension obligations to the beneficiaries of plans it has taken over.[2] This interest rate assumption is lower than the rate plans normally use to calculate their funded status and is even below the interest rate the Administration considers reasonable for plan funding purposes under its legislative reform proposal.

The PBGC claims that these unrealistically low interest rate assumptions are needed to approximate current annuity purchase rates. However, there is no evidence that anyone, particularly the agency, would actually pay to purchase private annuity contracts bearing these interest rates. The PBGC does not purchase annuity contracts and consistently earns a higher rate of return on its assets than the interest rate used to calculate its deficit.

Different schools of thought proffer what the appropriate interest rate assumption should be for purposes of calculating the PBGC's deficit. The PBGC uses the most conservative possible assumption, resulting in an interest rate assumption that is unacceptably low.[3]

Figure 1 illustrates how the PBGC deficit would change under alternative interest rate assumptions. One approach is to rely on a "yield-curve" – a measure of how interest rates change with respect to the maturity of obligations. This approach is the one recommended for pension plan funding by the Administration. Using a spot rate yield-curve to calculate the PBGC's liabilities reduces the deficit by about $5.0 billion to $18.4 billion.

Alternatively, using a weighted average rate based on high quality, investment-grade corporate bonds will further reduce the deficit to $14.3 billion. Finally, assuming a rate (7.5 percent) that approximates a conservative estimate of what could be earned on invested assets (and is an even lower return than the PBGC has earned in recent years) would put the deficit at less than $5.0 billion.[4]

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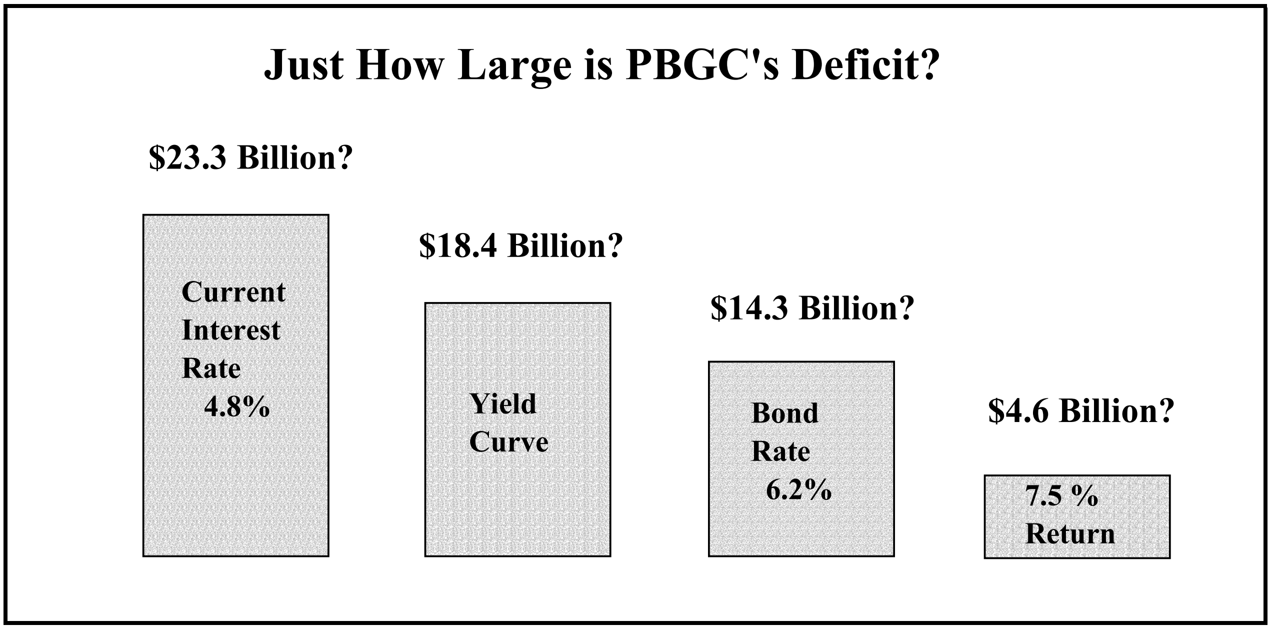
[2] For 2004, the agency assumed a rate of 4.8 percent for the next 25 years and 5.0 percent thereafter according to the 2004 Annual Report. Pension Benefit Guaranty Corporation 2004 Annual Report, p. 30.

[3] A recently released report by the Congressional Budget Office (CBO) fails to address the issue of the appropriate discount rate to be used for purposes of calculating the PBGC deficit or the extent of underfunding in defined benefit plans. Indeed, the report accepts the PBGC's estimate of its existing deficit without examining whether the discount rate used to value such deficit bears any relationship to the true nature of the liabilities the agency faces. *The Risk Exposure of the Pension Benefit Guaranty Corporation,* Congressional Budget Office, September 2005.

[4] For example, in its 2004 annual report, the PBGC reported overall returns on its assets of 8.0 percent for 2004 and 10.3 percent for 2003. Pension Benefit Guaranty Corporation 2004 Annual Report, p. 17.

Figure 1. PBGC's Deficit Under Alternative Interest Rate Assumptions



These examples demonstrate a fundamental principle of pension accounting: even small changes in the interest rate used to value future pension liabilities can have an enormous impact on the funded status of a plan and the size of the PBGC deficit. PBGC's deficit is overstated because an unrealistically low interest rate is used.[5]

Recent Economic Events Play a Primary Role in the Current Situation

The PBGC's deficit was exacerbated by a slumping stock market that, coupled with falling interest rates in the past few years, hurt the investment performance of all pension funds. It is useful to put this set of economic events in perspective. Historically, stock market returns and interest rates move in opposite directions, giving investment managers an important tool in balancing risk and return. Taking away this leverage will have adverse consequences on earnings.

One might ask if pension earnings can recover from the confluence of events that occurred in 2000. A recent Wall Street analysis suggests so:

> "…the extreme market conditions experienced in the 2000-2002 period are unlikely to be repeated soon. Between 1926 and 2002, equity markets and interest rates declined together in only 15 of the 77 years. Before the 2000-2002 span, there were no three-year periods during which both declined. If history is a guide, it seems likely that the economic and financial environment will be better for pension plans in the near future."[6]

[5] To put the figures in context, even the inflated liability of $23.3 billion represented only a tiny fraction of total payments out of defined benefit plans and even a smaller fraction of the unfunded liability of the retirement system for federal government employees.

[6] "Corporate Pension Plan Funding" by Kimberly A. Stockton, *The Vanguard Group, Inc.*, June 2004, p.9.

A recent study suggested that the funded status of defined benefit plans has rebounded in the last two years.[7] On average, the funded ratio – that is, the fraction of promised benefits that can be covered by existing assets – reached 90 percent and more companies reported a surplus in pension assets than in the prior year. In addition, investment returns on assets increased for the second year in a row.

PBGC's Investment Strategy Contributes to Its Problems

If pension earnings are rebounding economy-wide, can we expect that increases in the PBGC's investment returns can help alleviate its deficit in the future? Its investment returns will likely not keep pace with general market rates of return because the agency follows a very conservative investment strategy. The PBGC is required by law to invest the premium income it collects in Treasury securities. Furthermore, the PBGC's overall mix of all invested assets (primarily the assets of terminated plans it takes over) is overly conservative and heavily skewed toward fixed-income securities. Of the $39.0 billion in assets the PBGC controls, only 29 percent is invested in the stock market and the agency announced in its most recent annual report that it intends to reduce this fraction further.[8]

PBGC's overall mix of all invested assets is overly conservative and heavily skewed toward fixed-income securities.

Pension benefits are accrued and paid out over many years and a prudent investment strategy – one with a long-term perspective – takes this into account. This is why assumptions about interest rates and investment returns are so important in determining future liabilities. It is also why private pension funds tend to invest more heavily in the stock market. This belief is also fundamental to the Administration's proposal for personal accounts to help fund future Social Security benefits: individuals should be able to take advantage of the higher returns earned by equity investments. Much the same could be said about the PBGC. Its deficit will be much lower if a more balanced portfolio is in place.

Most Defined Benefit Plans are Not at Risk

The vast majority of the 34 million workers and retirees who are covered by single employer defined benefit pension plans need not worry about the security of their benefits because they participate in well-funded plans and there is no serious threat of default.

Over the PBGC's 30-year history, more than 165,256 defined benefit plans were terminated with assets sufficient to meet liabilities, compared to a mere 3,469 (2.10 percent) terminations of underfunded plans.[10] Thus, the vast majority of defined benefit plan terminations resulted in no liability to the PBGC. In 2004, of the 29,651 single-employer defined benefit plans insured by the PBGC, only 96 (.32 percent) were taken over.[11]

While recent high-profile plan terminations get significant media attention, the evidence over the long term suggests that most defined benefit plan participants will receive their benefits.

[7] Milliman 2005 Pension Study. Data cover the largest 100 firms sponsoring defined benefit plans with a fiscal year ending on or before December 31, 2004, and for whom annual reports were available by April 6, 2005.
[8] Pension Benefit Guaranty Corporation 2004 Annual Report, p. 5

[10] *Pension Insurance Data Book, 2004*. Pension Benefit Guaranty Corporation, p. 28.
[11] *Pension Insurance Data Book, 2003*, pgs. 27, 55.

A recent Goldman Sachs analysis addressed the concern of widespread defined benefit plan failures and the PBGC's statement that the defined benefit plans it insures are underfunded by $450 billion. The analysis states: "Quite frankly, if all of those sponsors were to fail, pension plan underfunding would be the least of the worries for the U.S. economy and the capital markets."[12]

The bottom line is that the vast majority of defined benefit pension plans remain adequately funded and are not at risk of terminating with unfunded liabilities.

The PBGC's Solvency is Not at Immediate Risk

PBGC's cash flow will enable it to continue paying out benefits for at least 15 to 20 years.[13] The PBGC Executive Director recently confirmed this situation in testimony before Congress:

> "Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years."[14]

Dire predictions about the future of the agency and the defined benefit system in general leave the impression that participants in plans taken over by the PBGC are at imminent risk of not receiving their benefit payments.

PBGC has no immediate solvency crisis. More importantly, most of the 34 million workers covered by the plan termination insurance program participate in defined benefit plans that are well-funded and at no risk of termination.

Some have even likened the current PBGC situation to the savings and loan situation in the late 1980s. This erroneous analogy ignores the basic fact that the PBGC's liabilities do not arise from demand deposits; the agency will pay its liabilities over a long period of time.

The vast majority of the 34 million workers and retirees who are covered by single employer defined benefit pension plans need not worry about the security of their benefits because they participate in well-funded plans and there is no serious threat of default.

The driving force in deciding what should be done about the defined benefit plan system should not be the PBGC's deficit estimates or its estimates of potential future liabilities. Instead, legislation should solve the current funding problems with defined benefit plans while ensuring that employers of healthy defined benefit plans remain in the system.

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[12] *Pension reform: Implications for plans sponsors and the capital markets.* Goldman Sachs. April 6, 2005.
[13] *PBGC: Updated Cash Flow Model from COFFI*, Center on Federal Financial Institutions, November 18, 2004. COFFI estimates that under every realistic scenario, the PBGC has sufficient assets to pay benefits until 2020.
[14] Testimony of Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation, before the Subcommittee on Retirement Security and Aging, Committee on Health, Education, Labor and Pensions, United States Senate, April 26, 2005.

III. WHY DO WE CARE SO MUCH ABOUT INTEREST RATE ASSUMPTIONS?

Unrealistically Low Interest Rate Assumptions Dramatically Overstate Pension Plan Liabilities

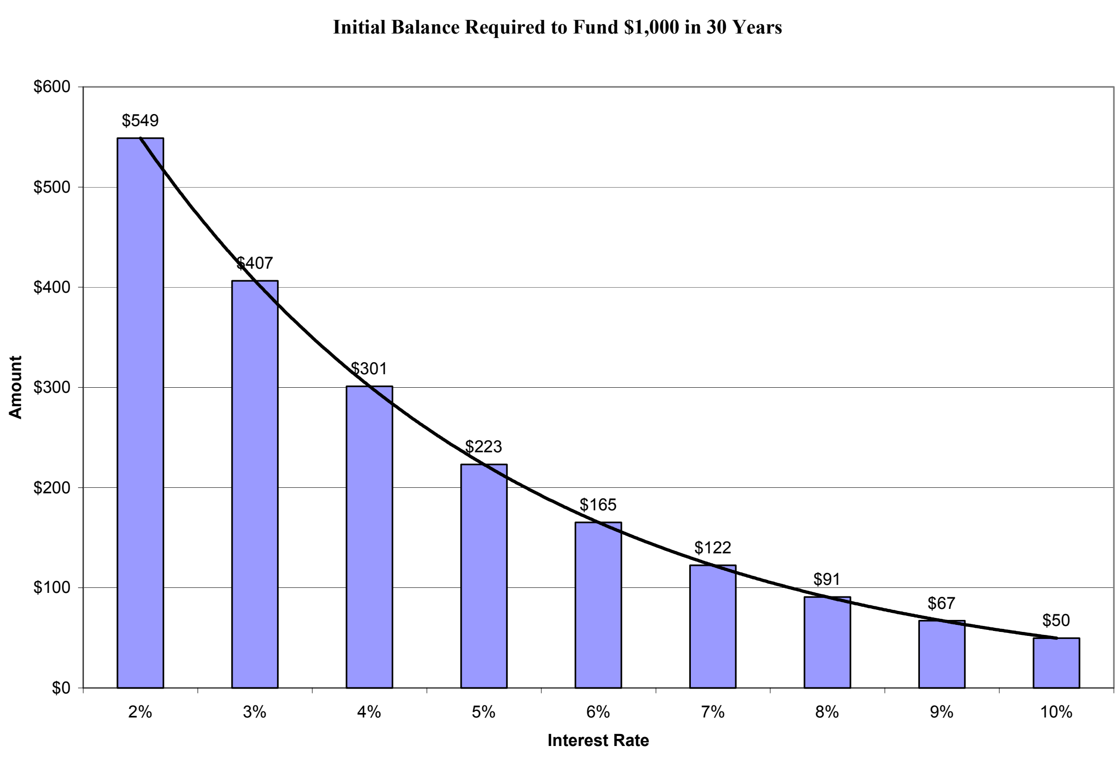
The funded status of a defined benefit pension plan is calculated by comparing the plan's assets to the present value of the plan's liabilities. The present value of plan liabilities is calculated by using a discount rate (interest rate assumption) that converts tomorrow's benefit promises into today's dollars.

In theory, the discount rate chosen should ensure that a defined benefit pension plan has enough assets to pay benefits as they come due. For an ongoing plan, the discount rate should take into account the expected future rate of return on pension plan assets. If these predictions turn out to be accurate, then the plan will have exactly enough money set aside to meet future funding obligations. Using a discount rate that is too low will understate future investment returns and overstate the amount of assets needed today to fund these obligations. The funded status of the defined benefit plan will look worse than it really is.

The calculation of the present value of defined benefit plan liabilities is extremely sensitive to the interest rate assumptions used. A one percentage point difference in the discount rate can alter the present value of defined benefit plan liabilities by 10 to 20 percent.

To help illustrate this concept, Figure 2 shows how even small differences in interest rates can have huge effects on required funding balances. More importantly, these differences get larger as the time horizon extends. For example, in order to fund a $1,000 benefit with a single, lump-sum payment 30 years from now, we would need an initial investment about 35 percent larger with a 5 percent assumed interest rate than with a 6 percent rate.

Figure 2.



Using a discount rate lower than the expected rate of return can be a conservative strategy and may be a prudent option for employers to offset the uncertainty of future market swings. However, the discount rate should not be so low as to cause adverse consequences both for defined benefit plan participants and sponsors.

Consider the Bethlehem Steel pension plan. In December 2002, the PBGC stepped in to terminate involuntarily the plan and it has since become the so-called "poster child" of the problems facing the defined benefit plan system.

The private annuity interest rate is the most conservative interest rate assumption the PBGC could use and, as a result, pension plan liabilities are consistently overstated.

When the PBGC took over the Bethlehem Steel plan, the company's last filings had indicated that the plan was 84 percent funded on a current liability basis ($4.2 billion of liabilities). Under the PBGC's calculations of Bethlehem Steel's termination liability, the company was only 45 percent funded ($7.8 billion of liabilities). The company used an interest rate assumption of 6.21 percent (i.e., the 30-year Treasury rate in effect at the time) in calculating current liability and the PBGC used a 5.0 percent interest rate to calculate termination liability. Although other factors (such as assumptions about early retirements) also contributed to the disparity between the funded status of Bethlehem Steel's plan as calculated by the company and by the agency, the interest rate disparity was a major factor.

Termination liability is calculated using an interest rate assumption below the rate that would be charged by a private insurance company to purchase annuity contracts to cover the plan's liabilities. Indeed, this interest rate assumption (3.4 percent for August 2005) is significantly lower than the interest rate the agency PBGC uses to calculate its deficit. But the PBGC does not purchase private annuity contracts; the agency pays participants' benefits directly out of its assets. The private annuity interest rate is the most conservative interest rate assumption that could be used and, as a result, pension plan liabilities are consistently overstated on a termination liability basis.

The Consequences of Overstating Defined Benefit Plan Liabilities

One might reasonably ask why we care whether the liabilities of defined benefit plans are overstated. The consequences of inappropriately low interest rate assumptions applied to defined benefit pension plans include:

- Reducing the benefits workers receive and thereby threatening their retirement security when the PBGC takes over an underfunded defined benefit plan.
- Adversely affecting the credit rating of the plan sponsor and thereby increasing the risk of insolvency.
- Triggering extraordinary plan contribution requirements and variable rate PBGC premiums, which may make cash-strapped companies more likely to terminate their defined benefit plans or enter bankruptcy.
- Causing lump-sum distributions to be overvalued relative to annuities; this in turn causes more participants to elect this option, which further decreases plan assets and exacerbates underfunding.

Unrealistically Low Interest Rate Assumptions Hurt Plan Participants Directly

Low interest rate assumptions can directly hurt defined benefit plan participants.

When the PBGC takes over a terminated underfunded defined benefit pension plan, some plan participants may have their benefits reduced immediately by the PBGC's benefit guarantee limits. Plan benefits in excess of the PBGC guarantees are paid only to the extent plan assets are available. Interest rates are relevant to this because, when plan liabilities are compared to plan assets, an inappropriately low interest rate will increase a plan's liabilities relative to its assets. While most lower-paid workers will get their full benefits, middle wage workers could see their benefit payments cut. In addition, when a defined benefit plan is terminated, workers stop earning benefits for future employment with the employer, further reducing their anticipated retirement benefits.

Looking again at the Bethlehem Steel example illustrates this problem. The Bethlehem Steel workers were hurt directly by the PBGC interest rate assumptions when the agency took over their plan:

(1) Participant benefits were limited to the federal guarantee level of $3,579.55 per month and participants received a smaller portion of their unguaranteed benefits;[15]
(2) Benefit increases that were phasing in under a 1999 labor agreement were only partially honored for PBGC benefit guarantee purposes, so participants lost a portion of these benefits; and
(3) Certain participants lost the right to $400 per month payments for plant closings or early retirement.

[15] By stepping in to terminate the plan in December 2002, the PBGC was able to limit the maximum benefit guarantees at the levels in effect for 2002, rather than the higher levels for 2003.

Valuing a plan's liabilities on a termination liability basis is based on an assumption that private annuity contracts will be purchased for the participants' benefits, which the PBGC does not do. It instead invests the plan's assets and pays benefits when they come due. The PBGC's rate of return has been consistently higher than this assumed discount rate (even with the PBGC's overly conservative investment strategy). Once the PBGC takes over a terminated defined benefit plan, the agency should consistently have more assets relative to liabilities than what was calculated on a termination liability basis.

The PBGC's rate of return has been consistently higher than the assumed discount rate, even with the PBGC's overly conservative investment strategy.

The overstatement of plan liabilities on a termination basis benefits the PBGC because:

(1) It pays smaller benefits to some plan participants than otherwise would be required; and
(2) As plan liabilities are overinflated and exceed plan assets, the PBGC acquires a greater interest in other assets of the employer. If the employer goes into bankruptcy, the PBGC may stand to recover more of the employer's assets in bankruptcy if the plan's liabilities are higher.

Unrealistically Low Interest Rate Assumptions Threaten the Defined Benefit Plan System

Statistics show an overall long-term decline in the total number of defined benefit plans maintained by employers, as well as a decline in the percentage of participants in such plans who are active workers. Moreover, current law funding rules discourage overfunding of defined benefit plans during economic good times and leave employers with large and unpredictable contribution requirements during economic down times when they can least afford it. Indeed, according to a 2003 Hewitt Associates Survey of Employer Perspectives, cost volatility was perceived to be the number one threat to the pension system.[16] A 2005 survey by Price Waterhouse Coopers confirmed that this issue remains a top issue for employers, with nearly 75 percent of large employers with a defined benefit plan identifying this as their number one concern.[17]

Employers "whipsawed" by interest rate assumptions that consistently make defined benefit plans appear to be in worse shape than they are and funding rules that discourage extra plan contributions during economic good times will more likely shed these liabilities in favor of the predictability of defined contribution plans.[18]

The overstatement of pension liabilities also contributes to a crisis of confidence among corporate shareholders and defined benefit plan participants. This, coupled with the adverse effect of the overstatement of pension liabilities on company credit ratings, will likely lead to further plan terminations and freezes.

Unrealistically Low Interest Rate Assumptions Overvalue Lump-Sums

From a retirement income security perspective, lump-sum distributions eliminate one of the advantages of defined benefit plans – retirement income paid on an ongoing basis over an individual's remaining life. Employees should not be discouraged from electing their retirement benefits in annuity form, rather than in lump-sum distributions.

Under current law, however, the interest rate assumption used to determine the value of lump-sum distributions is too low. The use of an overly conservative interest rate assumption to calculate the present value of a participant's accrued benefit (the lump-sum value) assumes that a participant who takes a lump-sum distribution will earn a below-market rate of return on their lump-sum distributions. As a result, plan participants will have an artificially inflated incentive to take lump-sum distributions instead of life annuities.

It is important to value lump-sum distributions accurately. The overvaluation of lump-sum distributions can also contribute to systematic underfunding of defined benefit plans by calculating funding obligations using one interest rate and then calculating the value of lump-sum benefits at a different, lower rate, thereby artificially encouraging participants to take lump sums rather than an annuity form of benefit.

As plan participants opt for lump-sum distributions, the plan assets may be depleted relative to what they should be, which could put the plan at greater risk of being unable to meet future benefit obligations.

In addition to the harm to the plan, studies have shown that plan participants who are provided a lump-sum distribution are more likely to use the distribution for nonretirement purposes than those participants who receive their benefits in the form of an annuity.[19]

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16 *Survey Findings. Current Retirement Plan Challenges: Employer Perspectives 2003*. Hewitt Associates LLC.

17 *Employers Express Strong Concerns Over Cost Volatility of Defined Benefit Pension Plans, PricewaterhouseCoopers Finds.* PricewaterhouseCoopers Management Barometer. August 24, 2005.

18 It should be noted that federal government contractors face even greater problems as they must follow federal contracting rules that do not treat additional deficit reduction contributions required to be made under the pension funding rules as recoverable costs under federal contracts. The federal contracting rules also generally require the use of different higher interest rate assumptions, different longer amortization periods for funding, and different funding methods than are permitted under the Administration's funding legislative proposal.

19 See the discussion of this issue in *Savings Under Tax Reform: What is the Cost to Retirement Savings?*, ASPPA Pension Education and Research Foundation.

IV. THE NEED FOR SENSIBLE LEGISLATION

Defined benefit plan system stakeholders recognize the need for a legislative response to the current situation. Any legislative solution should have, as a primary goal, the long-term stability of both the PBGC and the defined benefit plan system. Yet, it must also recognize that PBGC's problems are not caused by the defined benefit pension plans it insures, but rather can be traced directly to problems within specific industries unrelated to the current pension funding law.

The primary legislative goals that hold the key to the long-term health of the defined benefit system are:

A. A Permanent Interest Rate

The lack of certainty about the interest rate used for defined benefit plan funding purposes on a going-forward basis contributes to a loss of confidence in the defined benefit system by limiting the ability of employers to make long-term plans for funding obligations. The 2003 Hewitt Associates Survey of Employer Perspectives identified the lack of a permanent interest rate solution as a major threat to the defined benefit system. [20]

Ultimately, this interest rate must provide a reasonable estimate of the value of a plan's obligations so as not to overstate plan liabilities and reduce funding volatility and unpredictability.

[20] *Survey Findings. Current Retirement Plan Challenges: Employer Perspectives 2003*. Hewitt Associates LLC.

Furthermore, the interest rate for valuing lump-sum distributions should not be lower than that used for calculating an employer's funding obligations; a disconnect between these two interest rates artificially induces participants to choose a lump sum and creates a risk that employers will face persistent funding shortfalls as participants elect to receive lump-sum distributions in lieu of annuities.

B. Funding Reforms

The steady long-term decline in the number of defined benefit pension plans reflects the onerous regulatory burdens and substantial administrative costs imposed on these plans. Giving employers incentives to enter and stay in the defined benefit system would be a giant step forward in securing the retirement income of a substantial portion of American workers.

Giving employers incentives to enter and stay in the defined benefit system would be a giant step forward in securing the retirement income of a substantial portion of American workers.

Ultimately, the defined benefit plan system's health may be tied directly to the extent to which employers are not only required to fund adequately their defined benefit pension plans, but are encouraged to remain in the defined benefit plan system. The funding rules must ensure plan assets are sufficient to meet benefit obligations as they come due.

Further, the rules must permit employers to build up a cushion of plan assets by allowing additional plan contributions during economic good times and by minimizing cost volatility and unpredictability.

C. Investment of PBGC Assets

The PBGC engages in an overly conservative investment strategy with a significant percentage of assets invested in Treasury securities. Given that the agency will not have a solvency problem at any time in the near future, the PBGC should engage in a more balanced investment strategy. However, at least part of the PBGC's current investment mix rationale is governed by ERISA requirements that employer premiums be invested in Treasury securities. Any legislative solution should remove this restriction so the PBGC can increase its investments in higher-yielding fixed income securities and equities.

D. Hybrid Plans

The ongoing uncertainty concerning the legality of hybrid pension plans such as cash balance plans plays a significant role in the potential for a long-term solution to the crisis in defined benefit plans. Hybrid plans make up 25 percent of all defined benefit plans and are the source of 20 percent of the premiums paid to the PBGC.[21]

Employers have increasingly looked at cash balance plans to make plans more appealing to younger, more mobile employees. Yet the law governing these plans remains murky and existing plans have been increasingly subject to litigation.

The plans' ongoing legal uncertainty hamstrings employers struggling to address the needs of their changing workforce. Cash balance plans, by their design, helps employers manage their pension liabilities over the long run while ensuring that short-tenure employees earn a meaningful retirement benefit.

[21] Testimony of James M. Delaplane on behalf of the American Benefits Council before the Senate Committee on Health, Education, Labor and Pensions Subcommittee on Retirement Security and Aging, June 7, 2005, p. 12.

V. CONCLUSIONS

- The PBGC has protected the retirement income security of millions of U.S. workers for more than 30 years. No imminent funding crisis faces the agency.

- The vast majority of defined benefit pension plans are well-funded and there is no serious threat of default. But legislation that significantly increases funding obligation volatility or inappropriately expands administration costs will force employer plan sponsors from the defined benefit system entirely. Closing down pension plans is not the way to protect the benefits promised to future retirees. The defined benefit plan system is at a critical juncture and a sober look at the facts is required.

- The PBGC's deficit is overstated because unreasonably low interest rates overstate future liabilities. Further, much of the deterioration of PBGC's funded status resulted from the unusual economic circumstances of the last several years.

- The PBGC's overly conservative strategy for investing its own assets contributes to its deficit and is even inconsistent with the Administration's own proposal for personal accounts to fund Social Security benefits.

- Comparisons of the PBGC's current deficits to the savings and loan industry in the late 1980s are wrong. Pension funding requires a long-term perspective because benefits are paid out over many years. With history as a guide, and notwithstanding the possibility of more terminations of severely underfunded plans, much of the current defined benefit plan funding shortfall will be self-correcting after several years of recovery from recent economic shocks. Early indications suggest this is already happening.

- Legislation must be directed towards strengthening and securing the funding of benefits promised to the 34 million workers currently participating in defined benefit plans. Rules that offer more predictability in the way defined benefit plans determine their required pension contributions will do this.

Optimal Benefit Strategies

Optimal Benefit Strategies, LLC is a tax policy and economic consulting firm whose principals have over 50 years of Federal, state, and local tax experience. The firm offers a highly sophisticated, data-intensive approach to the analysis of complex tax policy issues, with particular expertise in the analysis of difficult employee benefit and pension issues, health issues, corporate tax policy issues, and general issues relating to the Federal income tax system. The principal authors of this paper were Mary M. Schmitt and John F. O'Hare.

Ms. Schmitt left her position as Deputy Chief of Staff with the Congressional Joint Committee on Taxation in 2004 after 22 years of service on Capitol Hill. Ms. Schmitt has extensive experience in all areas of federal tax policy, with an emphasis on issues relating to retirement plans and employee benefits and insurance companies and products. Prior to joining the Joint Committee in 2002, Ms. Schmitt worked for five years for the Internal Revenue Service, first in a key district office reviewing the first round of ERISA determination letter requests and later writing employee benefit regulations in the Office of Chief Counsel.

Mr. O'Hare has more than 20 years experience on Capitol Hill and as a consultant analyzing the impact of tax and economic policy at the federal, state, and local level. He has been responsible for the design and development of large-scale microsimulation models for both the individual and corporate tax sectors for use in assessing the effects of alternative policy scenarios on revenues, income distribution, tax burden, and economic growth.