S. HRG. 103-1012

RETIREMENT PROTECTION ACT OF 1993

Y 4. F 49: S. HRG. 103-1012

Retirement Protection Act of 1993, ...

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

S. 1780

JUNE 15, 1994

SUPERINTENDENT OF DOCUMENTS
DEPOSITORY

APR 18 1995

BOSTON PUBLIC LIBRARY
GOVERNMENT DOCUMENTS DEPARTMENT

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

88-738—CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046942-2

1157

S. Hrg. 103–1012

RETIREMENT PROTECTION ACT OF 1993

Y 4. F 49: S. HRG. 103-1012

Retirement Protection Act of 1993,...

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

S. 1780

JUNE 15, 1994

SUPERINTENDENT OF DOCUMENTS

APR 18 1995

BOSTON PUBLIC LIBRARY

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

88-738—CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046942-2

COMMITTEE ON FINANCE

DANIEL PATRICK MOYNIHAN, New York, *Chairman*

MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas
DONALD W. RIEGLE, Jr., Michigan
JOHN D. ROCKEFELLER IV, West Virginia
TOM DASCHLE, South Dakota
JOHN B. BREAUX, Louisiana
KENT CONRAD, North Dakota

BOB PACKWOOD, Oregon
BOB DOLE, Kansas
WILLIAM V. ROTH, Jr., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
DAVE DURENBERGER, Minnesota
CHARLES E. GRASSLEY, Iowa
ORRIN G. HATCH, Utah
MALCOLM WALLOP, Wyoming

Lawrence O'Donnell, Jr., *Staff Director*
Lindy L. Paull, *Minority Staff Director and Chief Counsel*

CONTENTS

OPENING STATEMENTS

	Page
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York, chairman, Committee on Finance	1
Conrad, Hon. Kent, a U.S. Senator from North Dakota	2
Rockefeller, Hon. John D., IV, a U.S. Senator from West Virginia	2

COMMITTEE PRESS RELEASE

Finance Committee Sets Hearing on the Retirement Protection Act 1

ADMINISTRATION WITNESSES

Reich, Hon. Robert B., Secretary, U.S. Department of Labor, Washington, DC 3

Samuels, Hon. Leslie B., Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, DC 6

AGENCY WITNESS

Slate, Hon. Martin, Executive Director, Pension Benefit Guaranty Corporation, Washington, DC 8

CONGRESSIONAL WITNESSES

Jeffords, Hon. James M., a U.S. Senator from Vermont 22

PUBLIC WITNESSES

Barnette, Curtis H., chairman, Bethlehem Steel Corporation, Bethlehem, PA, on behalf of the Pension Issues Coalition 28

Hirschland, David, assistant director, Social Security Department, International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), Detroit, MI 30

Labedz, Chester S., Jr., vice president, human resources, Textron Defense Systems, Wilmington, MA, chairman, Title IV Task Force, the ERISA Industry Committee (ERIC) 32

Spira, Robert M., Esq., director of government relations and senior corporate counsel, Leaseway Transportation Multiemployer Pension Plan Solvency Coalition 33

Calimafde, Paula A., J.D., chair, Small Business Council of America, Bethesda, MD 40

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

Barnette, Curtis H.:
- Testimony 28
- Prepared statement 45

Calimafde, Paula A., J.D.:
- Testimony 40
- Prepared statement 47

Conrad, Hon. Kent:
- Opening statement 2

Hirschland, David:
- Testimony 30
- Prepared statement 51

Page

Jeffords, Hon. James M.:
- Testimony 22
- Prepared statement 55

Labedz, Chester S., Jr.:
- Testimony 32
- Prepared statement with attachments 63

Moynihan, Hon. Daniel Patrick:
- Opening statement 1

Pryor, Hon. David:
- Prepared statement 88

Reich, Hon. Robert B.:
- Testimony 3
- Prepared statement 89

Rockefeller, Hon. John D.:
- Opening statement 2

Samuels, Hon. Leslie B.:
- Testimony 6
- Prepared statement 94

Slate, Hon. Martin:
- Testimony 8
- Prepared statement with attachment 108

Spira, Robert M., Esq.:
- Testimony 33
- Prepared statement 114

COMMUNICATIONS

American Council on Education 118
American Institute of Certified Public Accountants 121
Associated General Contractors of America 124
Champion International Corporation 126
Committee on Employee Benefits 131
Loews Corporation 133
National Employee Benefits Institute 135
Principal Financial Group 138
U.S. Chamber of Commerce 141
U.S. General Accounting Office 147

RETIREMENT PROTECTION ACT OF 1993

WEDNESDAY, JUNE 15, 1994

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:09 a.m., in Room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan, Chairman of the Committee, presiding.

Also present: Senators Baucus, Bradley, Pryor, Rockefeller, Conrad, Packwood, Roth, Durenberger, and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H–37, May 25, 1994]

FINANCE COMMITTEE SETS HEARING ON THE RETIREMENT PROTECTION ACT *

WASHINGTON, DC.—Senator Daniel Patrick Moynihan (D–NY), Chairman of the Senate Committee on Finance, announced today that the Committee will hold a hearing on S. 1780, the Retirement Protection Act of 1993, the Administration's proposal to improve pension plan funding and limit the exposure of the Pension Benefit Guaranty Corporation (PBGC).

The hearing will begin at *10:00 A.M. on Wednesday, June 15, 1994,* in room SD–215 of the Dirksen Senate Office Building.

"Pension underfunding is a serious issue," Senator Moynihan said in announcing the hearing. "The Committee looks forward to hearing from the Administration on its proposal to strengthen pension funding requirements to assure retirement security for workers and retirees and keep the PBGC on sound footing."

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. A very good morning to our distinguished administration witnesses and to our guests and to the panel that will follow. This morning we are going to hold an initial hearing on S. 1780, a bill to amend the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 to provide security for workers, to improve pension plan funding, to limit growth in insurance exposure, to protect the single employer plan termination insurance program, and for other purposes.

This is an administration bill drafted by our most distinguished Secretary of Labor with the collaboration of the Department of the Treasury, represented by Hon. Leslie Samuels, the Assistant Secretary for Tax Policy, so well and favorably known to this committee; and by Hon. Martin Slate, who is the Executive Director of the Pension Benefit Guaranty Corporation.

---

* See also, a Joint Committee on Taxation print prepared for the hearing entitled Description and Analysis of S. 1780 ("Retirement Protection Act of 1993"). (JCS–4–94), June 14, 1994.

As with any arrangement of this kind, it needs attending on a periodic basis. But some events have taken place that make this more urgent than might otherwise be the case. So we very much look forward to hearing the views of the Secretary and the Treasury and the Corporation.

Senator Conrad is particularly knowledgeable in this area. He might want to make an opening remark.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Mr. Chairman, given the number of witnesses we have here today, I will withhold from making a full statement. I would like to point out, however, that of the $53 billion in estimated unfunded liabilities in single employer defined benefit pension plans in 1992 the government at the current time is only on the hook over and above the resources that it currently has for some $2.9 billion.

So even though there is substantial underfunding in the system the Federal Government at this stage is only obligated for a deficit amount of some $2.9 billion which is guaranteed by the PBGC.

That may not be much comfort given the pressures that will exist for the Federal Government to respond as this problem becomes more apparent and especially as we move into a period in which more and more people are retiring and the pensions they were counting on are not there. That will put substantial pressure on the Federal Government to respond.

Mr. Chairman, I think this is a very important subject. It is timely that you have called this hearing today and I thank you for it.

The CHAIRMAN. We thank you for being here.

Senator Packwood is involved in a Commerce hearing, as Senator Pryor is also at another hearing. We are at that moment in the legislative cycle.

Senator Rockefeller is here and we welcome any remarks from you, sir.

OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER IV, A U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Mr. Chairman, I would just repeat what Kent Conrad said in thanking you for holding this hearing. Pension underfunding is a great lurking black cloud over the horizon. Not many people know much about it, and it is a very difficult subject. Of the $53 billion in total pension underfunding, I think $38 billion comes from what we know well to be troubled industries: steel, tire, and automobiles.

The CHAIRMAN. We are going to hear from Hank Barnette, for example, later on.

Senator ROCKEFELLER. There is a lot of work to do.

The CHAIRMAN. Work to do, so let us get about that most industrious of Cabinet officers who is everywhere and involved in most everything and very constructively so. Mr. Secretary, we welcome you.

STATEMENT OF HON. ROBERT B. REICH, SECRETARY, U.S. DEPARTMENT OF LABOR, WASHINGTON, DC

Secretary REICH. Thank you, Mr. Chairman. I do want to thank you personally for introducing this bill and also thank you and the committee for scheduling the hearing and taking the time out. Word has it that you are engaged in other pursuits as well, legislatively. This is, as Senator Rockefeller and Senator Conrad indicated, a cloud on the horizon. It is not yet a crisis, but it is a serious cloud.

The CHAIRMAN. Did not Franklin Roosevelt use the Biblical image—a cloud no bigger than a man's hand. I think we would put it that way rather than a black cloud looming over the horizon.

Secretary REICH. It is a cloud no bigger than a man or a woman's hand. But I think it is——

The CHAIRMAN. Oh, God, I forgot.

Secretary REICH. Times have changed since F.D.R.

But in all seriousness, and this is a serious matter, if I may submit my testimony for the record and simply proceed——

The CHAIRMAN. Please, for the record, and you proceed exactly as you like and as long as you feel you wish.

Secretary REICH. Mr. Chairman, you have already introduced to my left Martin Slate, Executive Director of the Pension Benefit Guaranty Corporation, to my right Leslie Samuels, Assistant Secretary of the Treasury for Tax Policy.

When the Clinton Administration came into office, I, as the Chairman of the PBGC, set out to find out the facts and also to come up with legislative solutions. There had been a lot of talk about problems. We wanted to make sure that we understood the nature of the problems and also came up with a solution that was targeted precisely to deal with the problem, not to burden companies that were not underfunded, but to deal in a very surgical way with the underfunding.

Let us be very clear about the nature of the problem. With regard to defined benefit plans, and the defined benefit pension plans, as you know, are a very, very large part of our pension system. There are 41 million American workers right now who are dependent on defined benefit pension plans when they retire.

There are about 65,000 defined benefit plans. This is still a very good system. It is a very solid system. our discussion today should in no way imply that this is not a solid and very important system on which many American workers are dependent for their pension security.

The problem is confined to a small part of the universe. There are about 8 million American workers who are working for companies who are actually in plans that are substantially underfunded. They are in some jeopardy with regard to their pension security. Underfunding has increased substantially.

The CHAIRMAN. About 8 million.

Secretary REICH. Of the 41 million workers who are covered by defined benefit plans there are 8 million who are now in plans that are substantially underfunded.

The CHAIRMAN. That is 20 percent.

Secretary REICH. Yes. And the trajectory of the problem, that cloud on the horizon, is getting larger at an alarming rate. In 1987

there was $27 billion in underfunding. Now the most recent data are for 1992, and it is up to $53 billion in underfunding and that is about twice.

The PBGC's own deficit is now $2.9 billion. But that has doubled in the last 5 years. So what we are seeing is a cloud that is becoming a larger and larger cloud. Why we are so eager to advance this legislation and so eager that you take it up as you have is that while it is not a crisis now, it could easily become a crisis unless we do something about it. And now is the perfect time when the economy is in recovery, when jobs are coming back, when profits are being restored to do something about it.

If we waited for the next economic problem, the next economic downturn, and economies, as you know, do subscribe to Isaac Newton's law, that is, everything that is down eventually comes up; everything that is up eventually comes down. If we waited for the next economic problem we might be in a real crisis. I do not want to overstate that. It is easy to overstate the nature of the problem. But it is a problem. It is a growing problem. Now is the time to do something about the problem. It is the ideal time to do something about the problem and we feel that we have crafted a solution that deals specifically with the problem.

As I said, sponsors of well-funded plans will not be affected. There are four key provisions. I will outline them very, very quickly.

The CHAIRMAN. Mr. Secretary, take your time. We are here to listen. We have to legislate.

Secretary REICH. The first provision has to do with the actual funding laws, the funding provisions. The current funding provisions are simply too flexible. They allow too much wiggle room. They often allow companies that have unfunded plans 30 years to come up to full funding.

They are acting within their legal authority right now. I am not suggesting that any company that has an underfunded plan is acting illegally, but that is precisely the problem. There is simply too much latitude within the law right now.

The reform legislation takes out a great deal of this wiggle room. We accelerate the time in which underfunded plans have got to come up to full funding, and most new benefits have got to be funded within five to 7 years. We ensure in this legislation that companies with underfunded plans will not be able to minimize their contributions.

Again, I want to emphasize that fully-funded plans will not be affected by this. This accelerates the funding for plans that are behind.

The CHAIRMAN. And Mr. Slate is going to be able to tell us how he defines such a plan.

Secretary REICH. Yes, we will get into all of the details in a moment. I just want to give you the overview.

The CHAIRMAN. Right.

Secretary REICH. The second point is that this plan includes new compliance authority for the Pension Benefit Guaranty Corporation. Right now it is perfectly legal for a company to sell off a subsidiary that is in trouble.

Let us say you have a subsidiary with a plan that is very, very badly underfunded, but you have a healthy company. Well, the healthy company can sell off the subsidiary and essentially escape all liability. That subsidiary is then left with all of that underfunding liability and no longer has the cushion of the parent company to fall back on.

Not only are those workers of the subsidiary company exposed, but also, indirectly, the PBGC premium payers are exposed because the premium payers are backing up this entire system. Under this legislation, the PBGC would have better tools, so that if a company was about to sell off a subsidiary with a very badly underfunded pension plan, for example, they would have to notify the PBGC.

The PBGC at that point could enter court proceedings, could get all the information and, argue in court that this is not appropriate—that the transaction would leave these workers, and potentially the PBGC, holding the bag.

This is not possible right now under current law.

Another very important provision would eliminate the cap on the premium that is now paid by companies, a risk premium that is related to the riskiness of the pension.

Right now firms with 80 percent of the underfunding are only accounting for something like 20 percent of the revenues going into the PBGC. The incentives are not right. We have got to increase the incentives on firms with underfunded plans by adjusting the risk premiums they pay to better reflect the fact that they do represent a much, much larger risk.

Under this proposal those firms with very substantially underfunded plans would essentially end up paying about half of the revenues to the PBGC. Again, we do not want to handicap those firms. And this is a very carefully crafted piece of legislation; the risk premiums that those firms would pay would not be so much of a burden that those firms would go under. Obviously, that we do not want.

We want, and we think we have achieved, a careful balance in terms of their paying a responsible premium that reflects the real risk and not imposing upon firms with fully funded plans so much of the burden of paying for underfunded plans.

Finally, the fourth provision would be a disclosure provision. Right now, Mr. Chairman and members of the committee, many American workers simply do not know that they are in severely underfunded pension plans. We need a better disclosure provision. Workers need to have that knowledge. They need to be able to make reasonable and informed decisions based upon that information. They need to be able to apply pressure appropriately.

Right now there is a dearth of information out there. This proposal would provide disclosure to participants. Obviously, the more workers that know, the better.

These reforms, taken together, will assure funding of all vested benefits within 15 years and based on prior PBGC experience, will eliminate the PBGC's deficit within 10 years.

The administration is enthusiastic about the proposal and stands ready to help in any way. I realize again that this committee is dealing with many other issues at the moment, but I want to em-

phasize again—this is not a crisis, but it could become so if it is left unattended.

The trend lines are not favorable. Companies that have underfunded pension plans have too much wiggle room under the law, and now is the time to do something about it when the economy is recovering. This is the ideal time. We do not want to look back on this time years from now and say, why did we not handle the crisis before it was a crisis. Why did we not do something about it when we could have done something about it. That is relatively easy to do. It puts the responsibility exactly where it needs to be placed.

Thank you.

The CHAIRMAN. Thank you. Among other things, we do not want to look back and say, if a crisis should develop, we knew it was coming, we did nothing about it. You, sir, have brought it forward in a most clarifying way and not an intimidating way in the view of this member of the committee.

Senator Bradley, did you want to welcome our panel or just hear them out?

Senator BRADLEY. I am prepared to ask questions at the appropriate time.

The CHAIRMAN. Sure.

Senator BRADLEY. I think this is a very important hearing. I take what the administration said very seriously and I have questions that I would like to ask.

The CHAIRMAN. Good.

Well, then we will turn to Secretary Samuels. Good morning again, sir.

[The prepared statement of Secretary Reich appears in the appendix.]

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary SAMUELS. Good morning, Mr. Chairman. Mr. Chairman and members of the committee, I might begin by reaffirming what Secretary Reich said that on behalf of the Treasury and Secretary Bentsen, we appreciate, Mr. Chairman, your introducing this bill and you and the committee holding the hearing.

I would ask that my written statement be placed in the record.

The CHAIRMAN. Of course.

[The prepared statement of Secretary Samuels appears in the appendix.]

Secretary SAMUELS. I will summarize it this morning. I am pleased to present the views of the Treasury Department on the Retirement Protection Act of 1993. The Treasury Department actively participated in the administration's PBGC task force and the Department strongly supports this package. We believe that this legislation addresses the primary causes of PBGC's deficits in a responsible manner and before the situation becomes a crisis.

This morning I will discuss the portions of the bill that amend the Internal Revenue Code. Most of the amendments to the Internal Revenue Code in this legislation relate to the minimum funding rules. These minimum funding rules are designed to ensure that

employers sponsoring defined benefit plans set aside assets to secure the promised benefits.

The current minimum funding rules require sponsors of large underfunded plans to make additional deficit reduction contributions in order to eliminate the underfunding. In reviewing the effectiveness of these special rules, we determined that some employers with significantly underfunded plans had found loopholes in the statute that allowed them to minimize or even eliminate these deficit reduction contributions.

The bill modifies these funding rules in several ways to close the existing loopholes and minimize the ability of employers to manipulate their contributions in the future. These changes in the funding rules are the most important part of our PBGC reform proposal. Without them, we cannot ensure that employers will adequately fund the benefit promises they make to their employees.

I will spare you a discussion of the details which can be found in my written testimony and turn to some of the other significant tax related items in the legislation.

In reviewing the funding rules we found that the excise tax on nondeductible contributions was discouraging some employers from funding their plans as quickly as they and the PBGC would like. In response, the bill creates exemptions in the excise tax in two situations where the employer's nondeductible contributions are not motivated by a desire to obtain excessive tax shelter.

Now I would like to discuss the rounding rules for indexing values. Many of the statutory dollar thresholds and limits used in the qualified plan area are indexed to changes in the cost of living. The bill would modify the indexing rules so that new values for a year are available before the start of the year and would specify that the index values are rounded to even multiples of $5,000 or $500 in the case of Section 401(k) plan limits.

These proposals would simply administration by employers and communication with employees. As you know, Mr. Chairman, a similar rounding rule was added in this committee in last year's budget legislation.

Finally, I would like to turn to an important nondiscrimination issue, one that impacts on the integrity of the private pension system. As a condition of tax-favored treatment, Section 401(A)(4) of the Internal Revenue Code requires that retirement plans demonstrate that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees.

This can be shown on the basis of either contributions or benefits without regard to whether the plan is a defined contribution plan or a defined benefit plan. The bill would generally prohibit a practice known as cross testing a qualified defined contribution plan on the basis of benefits it is expected to provide.

Creative practitioners have developed aggressive plan designs that provide more contributions for highly paid employees than for everyone else and complied with the nondiscrimination rules by cross testing. The potential for highly compensated employees receiving substantial benefits in cross tested plans has received considerable press attention.

These press reports emphasize that highly paid employees can maximize benefits for themselves while minimizing contributions

for rank and file workers. For example, a June 1993 financial planning article is headlined "Skewed Retirement Plans Help Owners at Workers' Expense." Then an industry trade journal shows how cross testing can be used to reduce the allocation for rank and file workers from 15 percent of pay to 3 percent of pay while the owner continues to receive the maximum allocation of $30,000.

And finally, the Wall Street Journal leads its story with, "Is it a retirement plan or a tax shelter plan?" The administration is concerned that these practices reduce the share of tax subsidized retirement funds that go to rank and file workers and can encourage employers to abandon the defined benefit system, thus eroding the PBGC premium base.

Since the administration made this proposal, we have heard from many interested groups. The purpose of our meetings with these representatives have been to identify the types of plans that provide meaningful benefits to rank and file workers as compared to the abuse of cases. We have received useful suggestions. We hope that we can work with the committee in tailoring the proposal to target the troublesome cases.

In this process, however, are guiding principle remains. The recently developed abusive practices must stop. Our private pension system was not designed to be just another tax shelter, but to encourage employers to provide meaningful benefits to all the employees.

In conclusion, I would like to emphasize as Secretary Reich has, that now is the time to act while the PBGC's problems are still manageable. Enactment of the Retirement Protection Act of 1993 will require employer sponsoring defined benefit plans to do a better job of satisfying their commitments by adequately funding their plans thereby reducing PBGC's potential liability.

Mr. Chairman, this completes my statement.

The CHAIRMAN. Thank you. Thank you very much. Once again, that is very clarifying, that as with any large arrangement over time advantages will be found and tax shelters will appear. We just have to keep working at this enterprise. I found that very helpful. At least I did, and I cannot claim any large experience in this field.

I can claim some experience with our next witness. Mr. Slate and I have worked together in the past in academic settings. Mr. Slate is, of course, the Executive Director of the Pension Benefit Guaranty Corporation, a position that he was given as a reward for having served for 6 years as the Director of the ERISA Program in the Internal Revenue Service. Anybody who does that is entitled to some form of public recognition and minimum statement of gratitude.

Good morning, Mr. Slate. We welcome you, sir.

STATEMENT OF HON. MARTIN SLATE, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. SLATE. Thank you, Senator Moynihan. I hope you do not remember the grade you gave me.

The CHAIRMAN. You graduated Phi Beta Kapa.

Mr. SLATE. Thank you. I, too, would like to be brief. Secretary Reich and Mr. Samuels have underlined the seriousness of the

underfunding problem, the need to address it squarely and speedily and the goals of our reforms.

This is, indeed, the time to move forward to protect pension benefits. I would like to review our reforms and describe how and why they will work. Our reforms are straightforward. They are targeted to address clear problems. Our major reform measures will strengthen the funding rules for underfunded plans, enhance PBGC compliance authority, increase premiums for plans that pose the greatest risk, and broaden participant disclosure requirements.

Fully funded plans, most plans, will not be affected by our major reforms. Our primary reform is to strengthen the funding requirements for underfunded plans. In 1974 ERISA established the concept that money must be put aside currently for benefit payments due in the future.

The CHAIRMAN. That is not exactly a radical idea, is it?

Mr. SLATE. No. It has been in mortgages.

Senator BRADLEY. It is just one that has not been observed.

The CHAIRMAN. I see. It has not been observed.

Mr. SLATE. Right. Exactly. That is precisely the next sentence. But acute underfunding persists, in part, because companies were permitted to fund a portion of their benefit liabilities over a period of 30 to 40 years.

Thirteen years later Congress addressed funding again. OBRA-87 introduced an additional contribution requirement intended to accelerate funding in underfunded plans. Still, underfunding has grown since 1987. Companies can use credits and offsets and set actuarial assumptions so that contributions are minimized.

Fully within the law many employers have been able to make little or no pension contributions even though their plans are severely underfunded. As Senator Conrad mentioned, underfunding of ongoing plans has climbed to $53 billion in 1993. It was $27 billion 5 years ago. And the PBGC deficit, the cost that the government must bear for plans that are already terminated, is $2.9 billion.

To get funding back on track we make three changes. First, we would speed up the funding formula in severely underfunded plans. Most new benefits would be paid for within five to 7 years.

Second, our reforms remove a loophole from the law. We end the double counting of credits that has enabled employers to minimize contributions.

Third, our reforms require the use of specified interest rate and mortality assumptions to determine contribution amounts so that again employers cannot reduce plan funding by using aggressive actuarial assumptions. Our reforms also include a special solvency rule to ensure that severely underfunded plans meet their benefit obligations.

A plan would be required to meet cash equal to 3 years' worth of benefit payments. Accelerated funding is essential if plans are to be placed on a sound footing. We do want companies to move forward with their business. The legislation contains a special transition rule to protect employers from extraordinary increases in their annual contributions for up to 7 years.

This is especially important. The underfunding gap must be closed, but business and work must move forward. Strengthening funding rules should assure improvement in most cases. There are,

however, special circumstances where PBGC needs better tools to protect pensions.

All too often we have seen companies undertaking business transactions that endanger pension promises. A healthy corporation might spin off a subsidiary in poor health with an underfunded pension plan, leaving the subsidiary's plan without a source of funding because the corporate tie is broken.

The only remedy the PBGC has in these circumstances is to terminate the plan. This can be a harsh remedy because participants are hurt and the resulting claim for plan underfunding can have serious consequences for employers.

Our proposals would allow PBGC to apply to Federal Court for remedies other than plan termination. For example, PBGC could ask that a corporation selling a subsidiary continue funding the subsidiary's plan for a period of time. Our reforms are tailored. They would apply only when a company has a hugely underfunded plan and that company undertakes a transaction of a substantial nature and only when that transaction poses a risk to pensions. We want to protect the benefits, not hobble corporate transactions.

We also propose to require companies whose plans are underfunded by more than $50 million to provide PBGC with advance notice of transactions that might affect underfunding.

Next, we propose to increase premiums for plans that pose the greatest risk, by phasing out the current cap on PBGC's variable rate premium. PBGC's annual insurance premium for plans has two elements—a flat $19 per participant that's paid by all plans and a variable rate charge for underfunded plans.

The variable rate charge is capped at $53 per participant. Plans at the cap, as the Secretary said, account for 80 percent of all pension underfunding, but their premiums represent only about 25 percent of PBGC's total premium revenue. We need to put the responsibility where it belongs and change the incentives in the premium structure.

Finally, our reforms would require that timely, clear information on plan funding and PBGC guarantees be provided annually to participants in underfunded plans. These reforms will markedly increase funding in the most underfunded plans. They will assure that all vested benefits are funded within 15 years. They are targeted in very specific ways to correct current law and make it work. We build on the existing legal structure simply to fix what is wrong.

The reforms are comprehensive and balance. We think we have the fix for the problem and we think it is the right fix. Thank you.

The CHAIRMAN. Thank you, sir. Thank you for clarifying testimony.

[The prepared statement of Mr. Slate appears in the appendix.]

The CHAIRMAN. I want to welcome Senator Grassley. Good morning, sir.

I have just one question. First in the interest of full disclosure may I simply state that I find your arguments persuasive and I think the committee ought to act. It is refreshing to have a panel come and say you do not have to do anything this year but you will wish you had because there is this trouble out there waiting for you which you can avoid now.

The ERISA system has been in place just 20 years. This would be the second major change, I guess. There have been some changes.

Mr. SLATE. There have been changes along the way. Yes, there have been changes. In our area, Senator, there was a major law in 1987 that sought to address this underfunding problem, but it frankly did not work, as we pointed out. Underfunding in 1987 was $27 billion and it has gone up to $53 billion now. So we have taken a shot at it.

The CHAIRMAN. There will be those in the next panel, after we have Senator Jeffords, who will claim that the increase in reported deficits is really a matter of a change in the accounting rules.

We would like to ask you—I will ask the panel, but might I just ask you, Mr. Slate—if you will read the testimony that follows and maybe give the committee the benefit of your rebuttal, or you may be persuaded.

[A subsequent submission from Mr. Slate appears in the appendix.]

The CHAIRMAN. Why do you not answer that right now?

Mr. SLATE. Let me just flat out say that the General Accounting Office last month validated our deficit at $2.9 billion.

The CHAIRMAN. I see.

Mr. SLATE. We used generally accepted accounting principles and it was squarely and firmly validated by the General Accounting Office.

The CHAIRMAN. That is a pretty clear answer. I do not think I have any more questions.

Senator Conrad?

Senator CONRAD. Mr. Chairman, thank you.

Maybe I could turn first to Mr. Slate. How much of the $53 billion is in companies with below investment grade ratings or in these financially troubled institutions that you described?

Mr. SLATE. $14 billion. Of the $53 billion in underfunding $14 billion is in companies with below investment grade ratings. Just for the record, sir, that would include about 1.2 million workers who are in that kind of company.

Senator CONRAD. How much relates to troubled industries that do not have below investment grade ratings?

Mr. SLATE. $14 billion.

Senator CONRAD. Earlier I saw the number $38 billion that is related to the steel, automobile, and airline industries.

Mr. SLATE. Out of the $53 billion a large amount is in four industries—steel, air, auto, tire, and machinery. Those are the industries that are the most heavily impacted and the most heavily at risk.

Senator CONRAD. Does that represent $38 billion?

Mr. SLATE. It represents about 70 or 80 percent of the $53 billion, yes.

Senator CONRAD. $38 billion. The question I would have for you is, how much are we expecting these distressed and troubled industries to make in additional expenditures; and what is the evidence that they can afford those additional expenditures? Is there any question that those additional expenditures would threaten their viability?

Mr. SLATE. Senator Conrad, this was a major concern and one of the reasons that the Secretary appointed to his task force, not just pension people but people with economic expertise and financial expertise and so forth. We worked very, very hard to develop rules that were reasonable and affordable.

One of the reasons we put in the transition rule which would essentially minimize or reduce the bite of the new funding rules, is precisely because, while we think it is very important to fund pension plans, we also think it is important that people be able to continue with their business.

Senator CONRAD. Is there any question that these increases would threaten the viability of any of these firms? Secretary, do you care to respond to that?

Secretary REICH. Senator, I do not believe that the viability of any of these firms would be threatened by the increases in pension contributions called for under this plan.

Again, I want to emphasize that the transition rule which really puts a ceiling on how much they would have to pay in the range of, I think, 3 percent for the first 4 years——

Senator CONRAD. Three percent of——

Secretary REICH. For the first 5 years and then 4 percent. Three percent of what is essentially due in terms of underfunding. They would not have to suddenly come up to full funding. It is a gradual transition rule which enables them, over a substantial number of years to get their house back into order.

We did this specifically with those firms in mind so that they would not suddenly face a huge liability. But they could have enough time to adjust to fully funding pension promises to their workers.

We looked at individual firms. Again, there is no guarantee in life, but we tried to design this very carefully to avoid burdening any individual company in any one of those industries or for that matter any industry.

Senator CONRAD. So you are confident that the increase in pension funding obligations of these firms that are underfunded would not threaten the viability of any of these businesses?

Secretary REICH. I am confident.

Senator CONRAD. Let me ask you this. I am told that some experts say that a 1 percent reduction in interest rates increases liabilities 20 percent. I do not know if that is a good rule of thumb or not. Obviously, it makes a substantial difference if you change the interest rate assumptions. What happens to the projections of the liability in those out years? Is that a good rule of thumb?

Secretary REICH. I think actually I would make the rule of thumb a little bit less, Senator Conrad, probably maybe about half that much. But let me address the basic point.

There is a chronic and persistent mass of underfunding. Yes, it does go up and down with interest rates, but that mass is still there. It has continued. If you hold interest rates constant it continues and there is no question that we are talking about real money and real underfunding.

The trend is worrisome. That is, the trend regardless of interest rates, regardless of the economic conditions, that long-term trend is getting worse and worse.

Senator CONRAD. We have recently had an increase in interest rates. How would that affect the deficit number?

Mr. SLATE. Well, a drop in interest rates would increase liabilities. But I think our point is that even if you had held the interest rates constant, there would not have been a significant drop. And that until we change the law, that big mass of underfunding will continue and we have to reverse that.

Senator CONRAD. All right. Thank you.

The CHAIRMAN. Thank you, Senator Conrad.

Senator Rockefeller?

Senator ROCKEFELLER. Mr. Chairman, I only have one brief question for anybody who wishes to answer it. Senator Conrad asked about the effect of the increased payments on companies. Logically, if you think about this really quite serious, very serious, problem, there are not any other alternatives that I can think of. I doubt that one could get the Federal Government to substitute for those payments. I doubt that one could get that done legislatively.

So assuming that there are increased payments and assuming that for the most part companies can survive that, I think it makes sense for us to look at the tire industry, and maybe the auto industry, in terms of pension underfunding. On the other hand, a few years ago the steel industry was in a great deal of difficulty.

Now we are in a better period now, Secretary Reich, as you have indicated. So this would be a good time to strike. But you are quite confident that the cure would not put the patient out of business.

Secretary REICH. Senator, I am as confident as one can be. Now, again, there is no guarantee in life, there is no guarantee in business. But we have designed this in such a way as to minimize the burden.

Senator ROCKEFELLER. Are you estimating ways, and methods, and models?

Secretary REICH. Yes, we carefully estimated with a lot of actuarial modeling and a lot of investigation into these individual industries and companies. We tried to develop a transition rule that was realistic, that the companies could deal with but also at the end of the line that would not leave either the taxpayers or workers in these companies holding the bag.

You see, that is the fine line we are treading here. On the one hand we have to make absolutely sure that we do nothing to jeopardize these companies. That would be making——

Senator ROCKEFELLER. Because that is jeopardizing the worker.

Secretary REICH. It would be jeopardizing the workers and taxpayers.

Senator ROCKEFELLER. Yes.

Secretary REICH. But by the same token, we have to tighten the rules so that all companies, not just these companies, but all companies are going to be fully funding their pension plans at some point in the future and are on the right trajectory with regard to fully funding their pension plans so that workers and/or taxpayers do not get left out in the cold at the end of the day.

I want to commend the task force because they put in a great deal of time and energy. The two gentlemen sitting on either side of me deserve a great, great deal of credit for what they have come up with.

They looked very, very carefully at the question of the appropriate burden on these companies, these industries, and I am convinced that they have come up with a formula that is appropriate.

Senator ROCKEFELLER. Do you have any examples in these major industries, any of you, where there was ever a period of time where companies were not putting in their share because of what they deemed at that time or alleged at that time to be insufficient financial position?

Secretary REICH. Companies have taken holidays from funding their pension plans for a whole variety of reasons. Some we might deem quite legitimate, some we might deem completely illegitimate.

The point is that all companies that have severely underfunded plans need to develop a strategy for bringing those plans up to full funding. This particular piece of legislation enables them, encourages them, gives them all the incentives to do so.

Again, I want to emphasize, Senator, that we are all concerned, obviously, to ensure that companies are not overly burdened by any kind of a requirement like this. When the transition rules were developed, when this legislation was developed, there was extensive modeling of actual company data, using actual plan and company data in some of the companies with the most severely underfunded plans.

Now I want to add the obvious. That is that the economy is now in recovery. The modeling that was done did not assume a recovery. I want to state this for the record as clearly as I can. Years from now we do not want to be in the position of looking back and saying we should have done this because the PBGC is now overwhelmed, the public is left with a great liability.

Senator ROCKEFELLER. One more defining question or definitional question. You mentioned that some companies have taken a holiday and some for causes that were reasonable, some for causes which were not—you did not use the word unreasonable, but you used a similar word.

In this proposal, would there be a differentiation between companies who took a holiday for really a very unsubstantial reason and those who took a holiday for a substantial reason? In other words, do you differentiate between those two types or do you just treat everybody the same?

Mr. SLATE. I do not think that we look back and try to see who did what. I think our purpose is to try to get everybody to catch up. The companies are treated on the basis of their level of fundedness. If you are 40 percent funded you have to move a little faster than if you are 70 or 80 percent funded. But I think what our law would do is require companies to make the appropriate contributions, not put them in just in the case of the contribution holiday.

And, frankly, Senator Rockefeller, we worked very, very hard to make these provisions affordable. I do not know that affordability is the issue. I think that the issue is that we want to make sure that companies do not have the option to avoid paying for benefits that they have promised.

Senator ROCKEFELLER. I agree and I thank the Chairman.

The CHAIRMAN. Thank you, Senator Rockefeller.

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

I would simply like to applaud the panel's work and in particular the last statement by Mr. Slate. This issue has an ominous ring to it. There are distant echos of S&L crises here. We are not at that point. But the combination of moral hazard and adverse selection creates a dangerous combination where the Federal Government has the responsibility of guaranteeing pensions and where companies can opt out of the system, leaving a smaller and smaller group, paying higher and high premiums to pay for a larger and larger pool of pension liabilities that have been dumped on the Federal Government.

So I think that Mr. Slate's last comment as well as the testimony of the Secretary and Mr. Samuels is right on target. My questions really go to whether this is really enough.

When you look at the GAO analysis, you find that over 50 percent of the underfunded plans will not be required to pay additional amounts under the new funding rules. My question to you is, if we adopt your proposal, would you think this was the final solution. Do you think that we will have solved the problem here or are we not taking the strong medicine now because we hope that things will go away, but they will not go away and we will be back here in a couple of years asking for another change?

The experience of the S&L crisis is relevant. Strong action early would have averted massive exposure later. If we are at a similar position, I hope that we are not going to have a duplication of that unwillingness to be bold.

Mr. SLATE. I am glad that you asked that question. We did look at actual plans and actual data and we built on existing law. We have made our reform strong, but targeted at underfunded plans.

With respect to the GAO information, we looked at the underfunded plans that the new law does not pick up. And almost invariably those plans are making substantial progress. They are using reasonable actuarial assumptions and by and large their work forces are younger and there is time for them to move ahead. We wanted to cast our net firmly but we did not want to cast it any more broadly than we had to.

Senator BRADLEY. So the answer is?

Mr. SLATE. The answer is, we think we are on target and we think that we will correct the situation and God willing we will not be back here asking you for more help.

Senator BRADLEY. And the GAO report though talks about what they call hidden liabilities involved in pension plans whose sponsors are financially troubled. What are the hidden liabilities here?

Mr. SLATE. Let me address that. That is a separate issue. Their first issue is whether our funding rules are appropriate targeted. I believe they are. The GAO is concerned, as are we, that as you get closer to termination, liabilities tend to increase.

As an example, part of a work force may be laid off and they would be able to take early retirement. Another example is, as you get closer to termination an employer may not be able to put as much money into the plan as he anticipated. Our funding rules work very, very hard to try to anticipate that kind of situation.

We work very hard to try to anticipate the spiral that you get into when you are down at the end. But that is a fact of life in a poorly funded plan with a poor company.

Senator BRADLEY. So the more early retirements the greater the hidden liability?

Mr. SLATE. That is a possibility.

Senator BRADLEY. And what other, other than early retirements, would fit into this category?

Mr. SLATE. Basically it is early retirement, layoffs, severance benefits and that kind of thing.

Senator BRADLEY. Become liabilities on top of the pension?

Mr. SLATE. Well, presumably, hopefully, we put it all in the mix and try to anticipate it.

Senator BRADLEY. As best you can?

Mr. SLATE. As best you can, right.

Senator BRADLEY. So as a rule of thumb, that is a bit of information here. Now they have set up a program to try to deal with the problem of pensions on the one hand. On the other hand, to the extent you produce a policy that leads to earlier retirements, there is a tension there between the two.

The CHAIRMAN. Yes.

Senator BRADLEY. I thought I heard someone start to talk. If not, I will move on to the next question.

Secretary REICH. I was just going to say, Senator, that this policy that we are proposing and the plan represents a careful balancing act. We do not want to burden companies that have fully funded plans. We do not want to unnecessarily burden companies even if their plans are underfunded, in terms of jeopardizing them.

We do not think that we are, on the basis of the actuarial reviews we have done and also the company data we have used, encouraging any kind of adverse selection process. We are certainly cutting way back or way down on any moral hazard here.

Because we are adjusting the premiums, speeding the funding and we are requiring full disclosure, we are making a lot of adjustments that reduce or eliminate any moral hazard. You referred to the savings and loan crisis; obviously, that is on everybody's mind.

We are not there yet by any stretch of the imagination. Could we be there if we do nothing, given that the government is the guarantor? I cannot guarantee you that if we do nothing right now, if the Congress fails to act, that we will not be somewhere down the line in a savings and loan crisis.

Senator BRADLEY. But if we take these steps, we will go a long way to averting that.

Secretary REICH. If we take these steps we will go a very long way to averting this.

Senator BRADLEY. Now, these steps are not going to be universally supported by everybody. Mr. Samuels, therefore I would like to kind of open up a little bit the point you made about cross tested plans because this is a level of esotery that is sometimes missed.

But just to bring it alive here, or try to, for any nonexpert who is listening, you basically had your staff prepare an example where you had two employees, one 55 years old earning $150,000 a year and one 25 years old earning $20,000 a year. And under a tradi-

tional defined contribution plan, employers contribute the same percentage of compensation as all employees.

In this case it would be $4,500 for the $150,000 person and $600 for the younger person. Now, under a cross tested plan you point out the employer could provide a $30,000 benefit for the older worker and still only provide a $600 benefit for the younger worker.

Now, it is my understanding that what you have recommended will prevent this from happening. Is that correct?

Secretary SAMUELS. That is correct, Senator Bradley. It is those type of abusive cases that we are concerned about. Those are the type of cases that are the subject of these press clippings that are attached to my testimony, that people are going out and promoting these as tax shelters and we think that while it is an esoteric area, it is a very important one with respect to the integrity of the pension system.

Senator BRADLEY. How close to the traditional defined contribution plan will you reach?

Secretary SAMUELS. Senator, that is a question that we have had a lot of people come in to talk to us about. We are willing to have discussions about exactly how to draw the lines. We think there are some plans that come very close to meeting the traditional rules, but might have failed under our proposal and we are willing to discuss with the committee and its staff ideas to modify the proposals to make sure that we are really just touching the abusive cases.

Senator BRADLEY. Mr. Chairman?

The CHAIRMAN. Yes, sir.

Senator BRADLEY. Could I ask one more question?

The CHAIRMAN. Would you, please.

Senator BRADLEY. All right. The area of the provision of new benefits, you have a plan, the plan is in trouble, and yet your negotiations go on and new benefits are added to a plan that is already in trouble.

Under your proposal you have basically limited the provision of new benefits if the company is in bankruptcy. If it is in bankruptcy, you cannot then provide new benefits without collateral. My question to you is: Should it be broader than that? Do you consider even tougher measures? Why did you stop only with plans in bankruptcy? What should we be looking at in this regard?

Because it seems to me that on top of a weak plan that is underfunded not yet in bankruptcy but teetering on the brink and then sizable new benefits are agreed to with the ultimate result being it pushes it into bankruptcy and the taxpayer ends up having to pay the sizeable new benefits that were agreed to by the two parties that in the end will just simply pass it on to the Federal Government and the taxpayer, that maybe you should have gone a little bit more than simply the issue of bankruptcy.

Secretary REICH. Senator, we are in this proposal requiring that if companies that have underfunded plans offer any additional benefits, they bring those additional benefits up to full funding within five to 7 years.

Now some people might say, and I think you were asking the question, why draw the line there, why allow any additional benefits. I think the real issue here is fairness. Fairness to working

Americans, fairness to blue collar Americans. Managers generally have benefit increases built into their plans. Most wage earners, most blue collar workers, do not. Blue collar workers have to have their plans specifically amended to get any kind of an increase at all.

We felt again that in the careful balancing and weighing that we are doing, we do not want to prevent companies who have underfunding from providing any additional benefits at all to their blue collar workers, but again we want to crack the whip. We are saying, if you are going to do it, you have to be on a very accelerated schedule for fully funding those additional benefits.

Senator BRADLEY. I think that is a clear answer and I thank you very much.

The CHAIRMAN. We thank you, sir, for raising the parallel, possible parallel, of the savings and loan debacle.

I do not know whether anybody came forward and told the Congress, you know, this is coming unless you do thus and so. But we know it came and we have had this testimony, an equivalent situation. It also concerns the greater issue of savings, does it not, that your subcommittee will examine later this week?

Senator BRADLEY. Yes.

The CHAIRMAN. This is a form of capital formation. I am correct in that, am I not? If you put it aside you invest it. Senator Bradley is Chairman of the Subcommittee on—if you would like to have a set of problems—Deficits, Debt Management and Long-Term Economic Growth. He is going to take care of all those things on Friday.

Senator BRADLEY. Between 10:00 and 11:45.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Mr. Chairman, before I ask questions on this very important question or issue you have before the committee, could I make for 45 seconds a point on the nomination because I cannot be here?

The CHAIRMAN. Surely. Of course.

Senator GRASSLEY. First of all, I have no objection to these nominations being reported out. But I do have some written questions for Ms. Lau.

The CHAIRMAN. Of course.

Senator GRASSLEY. I would expect responses before Senate confirmation comes up on the floor.

The CHAIRMAN. Done.

[See "Nomination of Valerie Lau," S. Hrg. 103–646.]

Senator GRASSLEY. More importantly, I do have a problem with Mr. Noble's nomination. I am not going to object to our committee working as I said. But during Mr. Noble's last confirmation I had a commitment from him to meet and work with me on carrying out Congressional intent regarding Treasury's report on terrorists assets. To my knowledge, there has not been any attempt whatsoever to fix this problem. So clearly I think a promotion is premature at best.

Hopefully more cooperation will be more forthcoming and hopefully more cooperation will be forthcoming before they expect the nomination to get through the Senate.

The CHAIRMAN. I predict that Mr. Noble will be calling on you. [Laughter.]

The CHAIRMAN. Fearless forecasts.

Senator GRASSLEY. However the system works. I am not sure I know.

[See "Nomination of Ronald K. Noble, Frank N. Newman, Leslie B. Samuels, and Jack R. DeVore, Jr.," S. Hrg. 103–145.]

Senator GRASSLEY. Now, I do not know I can do any better than Senator Conrad and Senator Rockefeller did on a couple questions I want to ask. Before I ask a couple questions though I would just simply say as a matter of reaction to some points that have been made by the three of you on the panel, obviously it is probably correct for you to say that there is fine tuning of the present law in your suggestions. I do not argue with that characterization.

But I think it would be misleading to use the term fine tuning without realizing that there is a tremendous—let me put it in terms of billions of dollars of impact upon industry and business and should not—even the slightest changes might make billions of dollars of difference.

We have a problem here that we have to work with and I can appreciate that. But I hope that we are cognizant of that as well as you use the terms fine tuning.

I suppose I should start first with Mr. Slate. This is in regard to the interest rate question that has previously come up, I think, by Senator Conrad. At least one of the witnesses on our third panel makes a criticism about the policy that is used to compute their pension liability in relationship to interest rates.

As I understand it, this witness says that the assumptions required by the law are much too conservative. They say that pension plans typically can earn better rates of return than the bill says they should assume and that this thus causes them to overstate their pension liability.

I would like a response to that specifically. Are the assumptions that would be required by the bill too conservative and, if so, why are they? Why have you decided to make them that way?

Mr. SLATE. I think the assumptions, Senator, are appropriate. We are simply asking employers to fund pension plans so that people will not lose their benefits if their plans terminate. History has shown that companies will take advantage of the flexibility in the law and reduce contributions by using aggressive interest rates.

We are asking them to use Treasury interest rates and they will get plans funded to pay benefits. These are interest rates that are used by insurance companies and it is roughly comparable to the interest rates used by the Securities and Exchange Commission. We want to get benefits funded to protect them.

Senator GRASSLEY. You are saying that they are not too conservative then. What about the point that the Federal Accounting Standards Board only requires the use of a corporate bond rate for corporate financial statements? Why should the standards for pension plans be more conservative than that?

Mr. SLATE. I am not sure I necessarily follow that. We are using the same interest rates that the Securities and Exchange Commission is currently requiring. We have to make sure people do not

lose benefits. That is what insurance companies do. That is what the Securities and Exchange Commission does.

Senator GRASSLEY. I will have to check that out. It was my understanding that it was not the same and the Federal Accounting Standards Board was somewhat different. If I am right and you are wrong, I will get back to you and ask for something in writing.

Mr. SLATE. Sure.

Senator GRASSLEY. Also for you, one of the other aspects of the bill criticized by some is, as I understand it, the requirement that the uniform mortality assumptions be made by all companies. The argument is made that the mortality experience of the companies can differ considerably. Consequently, there should be some variation in that and you do not allow that.

Mr. SLATE. Well, again, yes, we want to get pensions funded so that people do not lose their benefits. The task force, if there was one thing we found, was that companies have too much flexibility to reduce funding by the use of actuarial assumptions.

We need to take the wiggle room out of the laws as the Secretary has said, and see that plans have enough money to pay their benefits if they terminate. The provision we are proposing, GAM 83, is the nationally recognized standard to determine termination liability to get pensions funded. It is used by States. It is used by insurance companies. And we need a uniform standard to make sure that companies fund pensions.

If I could go on a second, history has shown that companies will take advantage of the situation if assumptions are not standardized. A couple of examples. Senator Conrad talked about the airline industry. We have one company in bankruptcy with $86 million in pension underfunding. Over the last 3 years they have paid only $2 or $3 million a year into their plan. A major reason has been the use of aggressive mortality assumptions to reduce contributions.

That particular company is using a 1965 mortality table for a major part of its work force. 1965 was a long time ago.

He mentioned the auto industry. We have one automobile company that is using a mortality table that is pretty comparable to ours. There is another one right across the street that is using a table that assumes that twice as many people die each year. Those are two good examples.

The CHAIRMAN. That was before seatbelts. [Laughter.]

Mr. SLATE. Right. exactly. And those are two good examples of why we need to require companies to use assumptions that will assure that benefits are paid.

Senator GRASSLEY. I am done asking questions. Just a comment to clarify. I know there is something that has to be done in this area and that they must be sound. I just want to make sure that we do it in a way that does not have a one-size-fits-all approach and leads to a point where we are taking too much money out of the private sector for operation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. I think we completely agree on that.

Senator Packwood?

Senator PACKWOOD. I have just one question of Mr. Slate. On the underfunded companies, the really badly underfunded ones, you want to increase their rate of contributions to their plans and then have them pay a higher premium to you. Why not just have them put all of the money into their underfunded plan?

Mr. SLATE. The focus and thrust of our bill is on increased funding. That is where the major impact will be. We do feel that these companies have not been paying their fair share in premiums. We mentioned that plans that carry 80 percent of the underfunding are paying only 25 percent of the premium. We need to put the responsibility where it belongs. We want to put the incentive where it belongs.

In the end, we are simply asking people to pay $1 in premiums for every $100 in underfunding. And as underfunding goes down, and hopefully it will, the amount of premiums will go down.

Senator PACKWOOD. But the reason for your premium is make up for their lack of less than their payment in the past?

Mr. SLATE. To make up for the lack of less than fair payment, to get them to pay their fair share now, and to create an incentive for them to fund.

Senator PACKWOOD. Thank you, Mr. Chairman. That is all the questions I have.

The CHAIRMAN. Thank you.

Could I just make one comment? Senator Grassley, you can make the point that whatever is put aside for pensions does not leave the private sector. It is simply invested in other securities.

Senator GRASSLEY. I know that. But it would be out of—in the sense to which there is an obligation, real or not real, and you go and it were not real, then that would take money out of the operating.

The CHAIRMAN. That is right.

Senator GRASSLEY. That does not really take it out of the private sector, I know. But it does, in a sense, curtail the leeway of the corporate board to use it.

The CHAIRMAN. Precisely. But I note, I would like to ask just one last question. Perhaps Mr. Reich could give the answer. In the Wall Street Journal, September a year ago, it simply says, "By next year more than half of the 200 largest corporate pension funds could be underfunded according to a recent study by J.P. Morgan & Company's Asset Management Group." But this is no longer a problem of particular sectors that get into troubles that have nothing to do with their pension arrangement, but these are corporate decisions of some kind.

Secretary REICH. Yes. I think that needs to be emphasized, Mr. Chairman. Undoubtedly there are some troubled sectors historically. But what we are seeing increasingly is that as a matter of company strategy companies are abrogating their responsibilities, underfunding their pension plans, and potentially leaving workers and premium payers holding the bag. This must stop.

The CHAIRMAN. I put it to you that we have been given fair warning. I deeply appreciate the panel. I deeply appreciate the work you are doing. You will be hearing from us presently, just as soon as we have done health care reform, welfare reform, Uruguay Round and tax simplification. [Laughter.]

The CHAIRMAN. Thank you very much. It is a great honor to have you here.

Now we are going to hear from our colleague who has been patiently waiting. Senator Jeffords from Vermont has some legislation in this field. We are pleased to have him here and to speak to the particular bill that you have. You have a statement, of course, which we will place in the record and you proceed exactly as you wish, sir. You are very welcome.

[The prepared statement of Senator Jeffords appears in the appendix.]

STATEMENT OF HON. JAMES M. JEFFORDS, A U.S. SENATOR FROM VERMONT

Senator JEFFORDS. Thank you, Mr. Chairman. In addition to what I have introduced, a bill which I will talk to, I think we have some additional information that I want to share with you, which will shed some light on some of the problems that we are dealing with with respect to the PBGC.

The CHAIRMAN. Could I just make the note that Senator Durenberger who has just arrived, I believe is a co-sponsor.

Senator JEFFORDS. He certainly is. I am proud that he is a cosponsor. It is a pleasure to be before you, Mr. Chairman. I have sat with great interest and listened to the panel before me and to their answers. I know that this is a difficult subject. I am a little concerned at your comments as to when this would be taken up. I know it was done with some mirth.

But this is a critical issue. I think the last time we got serious about it was 1987. So I hope that we will give it some urgent consideration. I know you will.

The CHAIRMAN. May I just here right now say that was purposes of levity after a fairly heavy discussion.

Senator JEFFORDS. I expected it was and I knew you wanted to clear that up.

I do not need to remind you that, of course, the Social Security system was not considered to be a pension plan but rather one to be supplemented by savings and private pensions. But I think what I would like to show you is a dramatic and disturbing connection between what is happening in health care and retirement income security.

There is some debate as to the urgency of the task of health care reform. But some people in my own State and across the country feel satisfied with the status quo and are nervous about health care reform. Mr. Chairman, the problems in our health care system affect almost everything in our economy. Pensions are no exception.

I would like to take a look at the graphs that I have brought with me. I have been very concerned about the trend many employers have taken in either underfunding pension plans or terminating them completely. My theory has been that employers are spending so much money on providing health care benefits there is not enough money in the coffers to provide for their employees retirement income.

Thus, many employers are making benefit promises they can never keep, knowing that the Federal Government will save the day with respect to that. But if you take a look at the startling

demonstration here, what has happened—on the left is private employer spending. And as you will see in 1965, these are in constant 1991 dollars, in 1965 there was more being spent on health care. In 1975 it was about even. In 1985 and starting about 1981 there was a dramatic shift, such that health care expenditures go way up and pension expenditures come way down.

The CHAIRMAN. Actually come down, yes.

Senator JEFFORDS. But if you look how we took care of ourselves and the States took care of their employees as far as the public sector, though we have kept our pensions up and improved them, and also was able to suffer the increased health care cost. But I just bring that up because these figures came from the Employee Benefit Research Institute to alert us to the pressures that these businesses are having in trying to keep up with their pension benefits.

So, if we do not get the health care costs under control, we are just not going to be able to get these things like pensions up and funded. And, of course, during that period of time, life expectancy increased, which is going to put a further drain on the pension plans. It is up about 6 years, five or 6 years, since 1965 to this year.

So as we look towards the future I think it indicates very strongly that we must be very careful what we're doing on the pension side. Because I think that we want to make sure that in solving the health care problem we do not rob the pension bank or else we are going to end up with lots of old healthy people living in one-room shacks. That is what is going to happen here.

Now on to the issue of the underfunded pensions. You have heard some excellent testimony on this. I will not go over a lot. But I would point out that the one big difference——

The CHAIRMAN. Please your time, sir.

Senator JEFFORDS. All right, sir. I would be happy to do that.

Today the PBGC guarantees over $53 billion in unfunded pension promises made by single employer pension plans. This unfunded liability, the PBGC estimates that over $13 billion will very likely be a real liability to the agency. The PBGC's current deficit at $2.9 billion in its single employer program is a dramatic increase over just a few years ago and the slowed down growth is nowhere in sight.

As you are aware, the problem is not new. Since before 1987 this committee and other committees dealing with pension issues have been aware of the fact that big companies in troubled times are able to take advantage of the Federal Government's defined benefit pension guarantee system. They promise big pensions to their workers, continually increasing benefits, while at the same time making the most minimal funding contributions permitted under the law.

These troubled companies eventually terminate their pension plans and shift the cost of their pension debt to the PBGC, renege on promises made to the workers and drive up the cost of those remaining in the system, often including their creditors and competitors.

Although we addressed this problem in 1987, unfortunately we did not go far enough. Here we are again in 1994 looking at the looming PBGC deficit. Companies and unions continue to use the

PBGC, not just as an insurer of last resort, but rather as a silent partner with deep pockets during contract negotiations for wages and benefits.

In the previous Congress Senator Durenberger and I introduced legislation that would make sure that companies that had underfunded pension plans would be held accountable for providing their workers the benefits that they promised. Workers need to be assured that employers' promises of increased pension benefits are more than a mere illusion.

Workers need to know that employers will be held accountable for the promises they make. An employer should only promise what it can afford.

Congress Jake Pickle, Chairman of the House Subcommittee on Oversight of the Ways and Means Committee also introduced a companion bill in the House. This Congress Senator Nancy Kassenbaum has joined Senator Durenberger and me.

I would like to take a moment to commend Secretary Reich and the other representatives of the Clinton Administration here today for their commitment in addressing the financial crisis. Although there are differences in the bills, they are predominantly in the way to get to our ultimate goal—getting underfunded pension plans funded.

As in health care reform, if we work on a bi-partisan basis we can solve this problem this year. Indeed,this is a much simpler task, as the issues are more limited and consensus more easily obtained.

The Pension Funding Improvement Act of 1993 is a three part bill. Part I of the bill includes stronger funding rules for underfunded pension plans to ensure faster funding of present underfunded obligations. That is very similar to the administration's bill.

The CHAIRMAN. It is very similar.

Senator JEFFORDS. Yes. Part II prevents a bad situation from getting worse, by requiring underfunded plan sponsors to immediately fund up their plan or put up collateral in order to increase pension benefits. It is what I would call the first rule of holes. If you are in a deep hole and you are having trouble getting out, the first thing you do is stop digging.

Part III of the bill includes a Congressional Budget Office and PBGC study of what premium increases would be necessary to balance the PBGC's accounts. Over the past 2 years the PBGC, the General Accounting Office and the Congressional Budget Office have all testified about the sorry state of our termination insurance program.

They also have stated that the problem will only get worse and at some point in time require Congressional bailout if changes in the law are not made. We can no longer wait to change the law. There is no excuse for allowing a small number of plans to continue to abuse our current system for their own advantage while placing workers, retirees and other responsible plan sponsors and taxpayers at risk.

Therefore, I respectfully ask this committee to act now. Let us work on a bi-partisan basis and iron out our differences to change the law. The future of the defined benefit plan system depends on what we do.

Mr. Chairman, I am pleased to be here and I know that you are going to give this urgent attention and I deeply appreciate that. I also deeply appreciate the support of my good friend, Senator Durenberger, in this case as well as Senator Kassebaum.

[The prepared statement of Senator Jeffords appears in the appendix.]

The CHAIRMAN. We thank you, sir, for being here, being ahead of us all in this regard. You heard, Senator Durenberger, having just arrived would not have heard Senator Bradley say we have the makings of a savings and loan crisis on our hands here. We can act now when it is doable or we can wait until it is ruining us.

I found myself very much persuaded by the task force. I gather your legislation is compatible with the recommendations of the administrations.

Senator JEFFORDS. Yes, it is. The only difference is that we say—and it gets into a problem which Senator Bradley I believe brought out—and that is, if you are getting worse and worse and even looking towards a bankruptcy possibility, the thing to do is you keep promising more and more and more knowing that you can keep everybody somewhat happy by the fact that the PBGC will be there if you do go bankrupt to pick up the tab. They say five to 7 years; we say now.

The CHAIRMAN. Right. That is Jeffords first law about what to do when you are in a hole.

Senator JEFFORDS. Right, stop digging.

The CHAIRMAN. Stop digging.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

The CHAIRMAN. Senator Durenberger, would you want to speak to this?

Senator DURENBERGER. Yes, Mr. Chairman, if I may. If I may begin by saying the one thing that I am looking forward to most in my next life is not having decisions about how I use my time dictated by other people. My staff tells me my exact movements starting at 7:30 each morning or whatever the case may be until I am finally relieved of duty sometime after an event which began at 7:30 pm.

Unfortunately, this morning some unknown person did not put this hearing on my schedule or I would have been here earlier. I wanted to say two things. One to you, Mr. Chairman, and to my Ranking Member, you are probably the only two people who have the capacity to take on this subject in the context of health care reform, welfare reform, and everything else that you have to do and not be overwhelmed by it. Because the dollar consequences are in the trillions, to say nothing of the politics which you have already alluded to in terms of the S&L's.

Second, to say that in every institution like ours there is always somebody who has the vision to be able to see these things coming because they have been fortunate or unfortunate enough to have accepted an assignment on a committee or been assigned to a subcommittee where you get stuck with something as arcane as the PBGC.

And over on the House side it is Jake Pickle and over here it is Jim Jeffords. This is arcane. I joined with Jim last year not only

because I could perceive it as a problem, but because of my enormous respect for his ability to take on an incredibly difficult subject and stick with it until it has been resolved.

So I am just glad that somebody—I think it was Senator Kassebaum at the beginning of a mark-up over in the Labor Committee, which you have to be at—and I should stop talking so we can both go—said Jim will not be here until he finishes at the Finance Committee and I turned to the person next to me and said, “What is he doing at the Finance Committee?” That is how I got here. [Laughter.]

The second point, besides saying hello to David Gustenson over there from PBGC who was in on the ground work of insurance reform and all of the stuff we keep saying we are going to do, the easy stuff in health care reform, but on loan from PBGC, helped me design the original. I need to reinforce what Jim said about not robbing the pension bank to solve the health security problem.

It is absolutely, absolutely critical. Last week the Labor and Human Resources Committee of which we are both members guaranteed that if their bill is passed and all their reform is done that health care expenditures in this country 10 years from now by the American people will be a minimum of 19 percent of our GDP.

I have to tell you, Mr. Chairman, looking at these charts, that is a guarantee that we are going to continue to keep robbing the pension bank, the retirement bank and a whole lot of other things. I know Paul Ellwood was in here once on this. If we do nothing it goes to 20 percent; if we do the Clinton-Kennedy bill it goes to 19 percent. And he said, well, it will never go to 20 percent.

He is right. If we do not do anything, out there a lot of voluntary activity who will not ever let it get to 20 percent. But if we do what was proposed by the Labor Committee last week where you have universal coverage, mandated employer payments, you have price controls in the form of premiums, you have all these little HCFAs masquerading as health alliances and so forth, I can guarantee you we will be at 19 percent and I can guarantee you, Mr. Chairman, that we will break somebody else’s bank in order to do it.

That is the really critical point that I wanted to make to substantiate Jim’s testimony today. That it is so important that when we do health reform we do it right and we look at the issue I raised yesterday in that back room when we were debating triggers and we were debating a triggering event which is a percentage of uninsured in America that at some point in time triggers a mandate.

So I said to my colleagues, before we try to define what we do in the event that a certain percentage of our fellow Americans are uninsured, why do we not define what we mean by insured. We have not done that. We have not defined universal coverage.

The CHAIRMAN. I have to report that the meeting concluded on that note.

Senator DURENBERGER. Right. But that becomes so critical. Because as Jim is pointing out to us here today, the universal coverage on the insured side is not a health issue. It is an income security issue. And in that regard, it is the same issue that he is presenting to us today. How do we subsidize by income, age, disability, whatever it is, access for every American for a private health plan? And how do we combine the resources that are committed to pen-

sions, to earnings, to savings, and to subsidize health plans in order to get that done?

It seems to me that is what the Labor Committee has been missing and that is also the challenge that is presented by our colleague from Vermont to this committee.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, we thank you, sir. We are particularly grateful to Senator Jeffords for this chart because among other things those red bars represent consumption. The blue bars represent savings.

Senator JEFFORDS. Right.

The CHAIRMAN. Do we have a savings problem? We surely do. If there is one rule, other than Jeffords' first law about what to do when you are in a hole, is that you never change just one thing. I think we have to pay very great attention to that.

We thank you very much. You are wanted in the Committee on Labor and Human Resources. It is very generous of you to come today, sir.

Senator JEFFORDS. Thank you. It is a pleasure to be here, Mr. Chairman.

The CHAIRMAN. We look forward to—Senator Packwood and I were just saying, we think we can legislate this year on this matter.

Senator JEFFORDS. That is very reassuring. Thank you, Mr. Chairman.

The CHAIRMAN. And now we have a panel from the affected, interested corporations and trade unions and trade associations. I see Mr. Hank Barnette coming up, our first witness, who will be—you are first, why do we not put you in the middle. Good.

The panel consists of Curtis H. Barnette, who is chairman of Bethlehem Steel who appears on behalf of the Pension Issues Coalition; Mr. David Hirschland, who is assistant director of the Social Security Department of the United Automobile Workers of America; Mr. Chester Labedz, Jr., who is vice president of Human Resources for the Textron Defense Systems and is Chairman of the Title IV Task Force to the ERISA Industry Committee; Mr. Robert Spira—do I have that right, sir?

Mr. SPIRA. That is correct.

The CHAIRMAN. Who is director of government relations and senior corporate counsel to the Leaseway Transportation Corporation on behalf of the Multiemployer Pension Plan Solvency Coalition; and finally, Ms. Calimadfde is not here. If she gets here, we will put her on.

In any event, here you are and very welcome indeed. We will put all statements in the record. Please proceed. We will have a problem of being in session too long after the Senate has gone into session, but we are very happy to hear you and we are going to give you all the time you want.

Mr. Barnette.

STATEMENT OF CURTIS H. BARNETTE, CHAIRMAN, BETHLEHEM STEEL CORPORATION, BETHLEHEM, PA, ON BEHALF OF THE PENSION ISSUES COALITION

Mr. BARNETTE. Mr. Chairman, good morning. Senator Packwood, good morning. It is a special privilege to appear before you again.

The CHAIRMAN. Yes, you are getting to be a regular here.

Mr. BARNETTE. I apologize, Senator, but trade, health care and pensions are interrelated and they deal with the very competitiveness of American industry. That is why we appreciate this privilege to discuss pensions with you this morning.

The Coalition consists of eight companies, including Alcoa, Westinghouse, Chrysler, Ford, General Motors, Northwest, Armco and Bethlehem Steel.

Last year the Coalition paid PBGC $105 million in premiums. That is about 12 percent of the PBGC total. We sponsor pension plans covering nearly 2 million workers and retirees and we back that with about $90 billion in assets.

We fully support the administration's goal of having a financially sound pension insurance program and we especially commend Secretary Reich, Executive Director Slate, Assistant Secretary Samuels, and their staffs. They worked long and hard. We appreciate their leadership on the legislation they have submitted to you.

Many members of our Coalition, my company included, have been supportive of many of the administration's reforms, especially health care. And we think certain provisions of the administration's bill, including the proposal to eliminate tax penalties for funding pension plans such as the excise tax on contributions and the proposal to establish a solvency rule to make sure pension plans do not run out of cash, make sense.

Other provisions, however, we think under close examination could be contrary to the interests of our employees and our workers. If I may just briefly comment on several of those.

First, the administration's proposal would require our Coalition and companies generally to fund pensions to a level that is simply above the level necessary to pay all promised benefits. This is because of the mortality and the interest rates that would be specified here are simply wrong as applied to our group.

Companies are required to reach this new level of funding very rapidly with increases that apply retroactively to already established benefits. In cyclical industries we need pension funding rules that allow us to weather high points and cyclical downturns. Weaker companies mean fewer jobs and weaker companies mean greater risks to the PBGC.

Second, the legislation proposes a premium increase. We respectfully suggest there is no need for that increase. PBGC now collects $1 billion each year in premiums. About a third of that is used to pay benefits. The reason for the proposed increase is to make the bill revenue neutral, to offset increased tax deductions from higher pension funding.

I guess the logic of that escapes us because if the bill itself is to reduce the risk, it would seem that less premium revenue, not more, would be required.

And third, a very general concern is with the broad and sweeping oversight provisions and powers that would be given to the Agency here.

We would suggest while some have argued that a crisis is at hand that there is no such crisis, that the financial condition of PBGC is not deteriorating, and that it will not become the next S&L crisis.

In fact, comparing apples to apples the deficit is simply not increasing. Since the 1980's the total reported deficit has grown from $1.5 to $2.9 billion. In 1989, however, the PBGC began to count "probable" terminations as part of its deficit, probable terminations that it believes might happen sometime in the future. Because of that and other changes of accounting methods, it really appears to be worse off. In fact, the deficit for actual terminations decreased during this period.

The trend in the funding level of pension plans should also be examined. Here pension plan underfunding is reported nearly double the past 6 years to some $53 billion. What is not reported is that while liabilities grew assets also grew. The result is that the funding ratios, the plan funding ratios, have basically stayed constant. There was no alarming deterioration and funding levels. The dollar amount of underfunding grew because the PBGC used a lower interest rate to estimate liabilities.

Recent interest rate increases, which we are also familiar with, therefore, will drive down this underfunding. It is difficult here to understand why action must be taken now to address underfunding that is a result at least in large part as a result of past decreases in interest rates which have now begun to increase.

Let me just close, Mr. Chairman, by saying this. There have been significant changes in accounting and other reforms that encourage sound pension funding. Members of this Coalition are taking extraordinary steps to fund their pensions. Chrysler has contributed more than $3.8 billion above the legal minimums to fund its plan. General Motors has recently announced a plan to contribute some $10 billion. Bethlehem Steel in the last 2 years has contributed $632 million to our plan. Westinghouse has announced a plan to contribute $200 million. This Coalition very much wants to work with this committee and with the Congress to bring about sound and constructive reform. While we support certain provisions of the administration's proposals, there are others we have difficulty with and we appreciate this opportunity to bring it to the attention of the committee.

[The prepared statement of Mr. Barnette appears in the appendix.]

The CHAIRMAN. We appreciate that attitude, that approach very much, sir. I am glad to know that profits are up and contributions in the pension fund are up also. that is all very reassuring.

Let us hear from the union side of this matter as many of the major firms that are on that list are union firms and have negotiated benefits. Mr. Hirschland, good morning.

88-738 O - 95 - 2

STATEMENT OF DAVID HIRSCHLAND, ASSISTANT DIRECTOR, SOCIAL SECURITY DEPARTMENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW), DETROIT, MI

Mr. HIRSCHLAND. Good morning. Thank you very much. I am happy to be representing the UAW which represents 1.4 million active and retired members, most of whom are covered by defined benefit pension plans. We thank you for the opportunity to testify on the subject of the proposed Retirement Protection Act of 1993 and the problems associated with pension plans that are less than fully funded.

The UAW commends the administration for its careful review of the financial status of pension funds, of the Pension Benefit Guarantee Corporation and of the security of the Retirement Income Protection afforded American workers.

We agree with the administration that there is no immediate crisis facing the PBGC. At the same time we also agree with the administration that there are a lot of concerns that can and should be resolved now. The proposed Retirement Protection Act of 1993 focuses on strengthening the funding rules for pension plans. The UAW applauds the administration for taking this positive approach towards resolving the problem of underfunded plans.

The UAW strongly opposes proposals which have been made by others to cut the PBGC benefit guarantees or to restrict benefit increases by encumbering corporate assets. Such proposals would penalize workers and retirees by reducing the security and adequacy of their retirement income.

The problem of underfunding of certain pension plans has not been caused by overly generous PBGC guarantees. The five-year phase-in of the guarantees under current law provides adequate protection against so-called death bed increases shortly before a plan termination.

Similarly, the problem of underfunding has not been caused by inappropriate or excessive benefit increases. While the plans negotiated by the UAW with the big three auto companies are currently less than fully funded, over the last two decades the benefits provided by the plans have continued to replace a relatively confident percentage of pre-retirement income.

Because the benefits provided under these plans are based on the flat dollar amount related to the worker's years of service rather than a set percentage of worker's wages, the benefit levels have to be adjusted every few years to keep pace with the growth in wages.

These ad hoc benefit increases simply accomplish the same result that happens automatically under salary related management pension plans. Thus, proposals that would restrict ad hoc increases in flat dollar plans would discriminate against rank and file workers.

In addition to negotiating ad hoc increases, the UAW has also negotiated special early retirement programs to assist in the downsizing of the big three auto companies. Again, these programs have not been excessive or irresponsible. Many other companies have instituted similar programs. Congress recently approved such a vital program to help produce the Federal work force. If the UAW had not negotiated these special early retirement programs at the

big three auto companies thousands of younger workers would have been laid off.

The problem of underfunding in certain pension funds is attributable to the fact that the company sponsoring these plans has not contributed sufficient monies to the plans. Thus, the obvious solution for Congress is to enact legislation requiring quicker, more secure funding of these plans.

The UAW supports a number of specific reforms to strengthen ERISA's funding rules and approve the funded status of pension plans. Specifically, we support tightening the deficit reduction contribution required under OBRA-87 to assure the plan's funded status actually improves.

We are pleased that the administration has included a transition rule in S. 1780 to make sure that the tougher funding rules do not jeopardize the economic viability of some companies. But we are concerned that the application of the transition rules changes pension liabilities due to fluctuations in economic conditions could lead to dramatic swings the amount of contributions which a company is required to make from 1 year to another.

The UAW believes that the funding increases resulting from increases in current liabilities should be smooth. This will have the same funding result as the administration's approach, but with a leveling of the contributions required in any given year.

The UAW also supports the enactment of a plan solvency role. The UAW opposes the provision in the administration's bill which would lift the cap on the variable rate premium. Instead of requiring companies with other funded plans to pay additional premiums to the PBGC, the UAW believes it would be preferable to have these funds go directly into pension plans.

We understand the administration's proposed increase in the variable rate premium in order to offset the revenue loss associated with the tougher funding rules and to make the overall bill revenue neutral, the UAW urges the Congress not to let the arcane rules of budget scoring force bad policy.

Since the tougher funding rules will help protect the PBGC from additional unfunded pension liabilities they should not be scored as revenue losers. The administration should not be required to find revenue sources to offset these prudent funding proposals.

There are two other items not covered by the administration's bill which the UAW believes should be addressed by Congress in any pension legislation. First, we believe Congress should clarify the right of plan participants to assert claims for non-guaranteed benefits they often lose in my unfunded plan terminations.

Second, we urge the Congress to reassert PBGC's role in guaranteeing pension benefits in situations where the benefits are being provided through the purchase of annuities from an insurance company.

In conclusion, Mr. Chairman, the UAW appreciates the opportunity to testify on the subject of the Retirement Protection Act of 1993. We are firmly committed to the objective of improving the funding status of pension plans. We look forward to working with you and the other members of this committee as you consider this critically important issue.

Thank you.

[The prepared statement of Mr. Hirschland appears in the appendix.]

The CHAIRMAN. We thank you, sir. I certainly want to agree about those arcane budget rules. It happens that in the administration's proposal the theoretical losses are offset by the theoretical gains from eliminating cross testing and premium increases. So they have anticipated this. But do not even think that I can explain it to you.

Mr. Labedz, good morning sir.

STATEMENT OF CHESTER S. LABEDZ, JR., VICE PRESIDENT, HUMAN RESOURCES, TEXTRON DEFENSE SYSTEMS, WILMINGTON, MA, CHAIRMAN, TITLE IV TASK FORCE, THE ERISA INDUSTRY COMMITTEE (ERIC)

Mr. LABEDZ. Good morning, Chairman Moynihan and members of the committee. My name is Chester Labedz. I am pleased to appear before you today on behalf of the ERISA Industry Committee.

In June of 1993 ERIC presented a plan to strengthen pension funding rules and the government program that guarantees benefits. The proposal reflects the consensus of a broad range of major employers on changes needed to provide an effective and coherent structure.

ERIC believes that its proposals are more consistent with the purposes of the termination insurance program and the mission of the PBGC as stated in ERISA than is S. 1780. Although S. 1780 is intended to address pension funding and security issues constructively, the bill does not address the fundamental problems facing defined benefit plans.

S. 1780 appears to be designed primarily to protect the PBGC rather than the plans that the PBGC insures. We would like to focus today on four features of the bill that give us particularly strong concerns.

First, S. 1780 would narrowly restrict or dictate the interest rates and mortality table that may be used to determine a plan's current liability for funding purposes. Although these proposals might appear to be technical and innocuous, they are extremely substantive and they will have a severe effect on pension funding requirements.

ERIC believes that the proposals are inappropriate and strongly objects to both of them. Our chart illustrates how the bill's mandated interest and mortality assumptions overstate the amount an employer needs to fund. The bars in the chart add together the liability of 10 diverse ERIC member plans.

The yellow bar shows the plans' combined liability based on expected long-term earnings on their assets. The dark blue bar is the same liability, but it is based on the rate of return on corporate bonds that is conservatively used in a company's SEC financial statements.

The green and light blue bars show that the bill's mandated interest and mortality assumptions respectively would add an average of almost 12 percent to the liabilities of these diverse plans. In some individual cases, S. 1780 will increase liabilities by as much as 20 percent over the already conservative SEC requirement.

Finally, the magenta bar shows the liability amount that plans must use to calculate their variable rate premiums.

Second, S. 1780 revises the current pension funding standards primarily by strengthening the deficit reduction contribution requirements of current law. ERIC believes that it is a mistake to focus on the DRC. The deficit reduction contribution applies only to plans that already have experienced funding difficulties. A deficit reduction contribution is thus an after-the-fact remedy. The deficit reduction contribution requirement also significantly increases the volatility and unpredictability of funding requirements.

Plans may bounce in and out of the bill's harsh requirements from 1 year to the next causing substantial and unnecessary disruption in a business's financial planning. We recommend that the committee focus instead on fashioning strong and appropriate basic funding standards that require faster funding of new obligations under the basic funding rules.

Third, S. 1780 includes a transition rule that limits the mandatory increase in the level of an employer's contribution for 7 years. This merely defers the full impact of the bill's funding requirements. The result of the administration's proposal is that an employer can hit a wall of new contribution requirements as soon as the transition period expires.

One company estimates that its annual funding obligations will virtually double in the first 2 years after the transition period expires. By contrast, under the ERIC proposal, companies would make higher contributions in the early years than what is required under S. 1780 but would not hit a contribution wall in the out years.

Fourth, S. 1780 requires employers to give advance notice to the PBGC of certain business sales and other dispositions and allows the PBGC to hold up the transactions to bring an enforcement action. We strongly oppose this provision.

The provision will allow the PBGC to interfere with and disrupt many normal, non-abusive business transactions that are not based on pension considerations. These provisions will affect many buyers and sellers of businesses, not just businesses with underfunded pension plans.

We urge the company to revise S. 1780 to accommodate——

The CHAIRMAN. You urge the committee.

Mr. LABEDZ. I am sorry. To accommodate the concerns I voice today.

Thank you, Mr. Chairman, for the opportunity to testify.

The CHAIRMAN. Thank you for very concise and informative testimony, sir. We will have questions later.

[The prepared statement of Mr. Labedz appears in the appendix.]

The CHAIRMAN. Mr. Spira on behalf of the Multiemployer Pension Plan Solvency Coalition.

STATEMENT OF ROBERT M. SPIRA, ESQ., DIRECTOR OF GOVERNMENT RELATIONS AND SENIOR CORPORATE COUNSEL, LEASEWAY TRANSPORTATION MULTIEMPLOYER PENSION PLAN SOLVENCY COALITION

Mr. SPIRA. Thank you, Mr. Chairman. My name is Robert Spira with Leaseway Transportation in Cleveland Ohio. I am pleased to

appear before you on behalf of the Multiemployer Pension Plan Solvency Coalition.

The Coalition represents substantially all of the employers who contribute to multiemployer pension plans. We recognize that S. 1780 does not address underfunding in multiemployer pension plans.

According to testimony by Secretary Reich at the House Ways and Means Committee in April 1994 the administration believes that multiemployer plans do not present a problem because underfunding has decreased since 1980. Therefore, legislation addressing multiemployer pension plan funding levels is not required.

We disagree with Secretary Reich. The administration's position ignores the facts. There is a problem. The problem is getting worse. It will not go away by itself. The favorable funding trends reported by Secretary Reich occurred in the 1980's. They are a thing of the past.

Since 1990 underfunding in multiemployer plans has more than doubled, from $5 billion to $11 billion. The recent increases in underfunding are even more significant when viewed in the context of the declines of the number of employees in these plans for whom contributions are made.

Many of these plans are in the trucking industry. Deregulation in 1980 resulted in a dramatic realignment of the trucking industry. Non-union segments have grown while employment levels in union trucking operations have declined. These changes in the trucking industry have had a negative impact on the union-sponsored multiemployer plans.

Many of the underfunded multiemployer plans have lost between 40 percent and 60 percent of their active employee participants. These declines are expected to continue. Each decline in the contribution base of an underfunded multiemployer plan has the effect of increasing the exposure of the union employers who remain.

In 1990 PBGC reported that 89 percent of all multiemployer plans covering approximately 80 percent of all multiemployer plan participants were fully funded for vested benefits. By 1992, however, only 80 percent of all multiemployer plans covering approximately 68 percent of all multiemployer plan participants were fully funded for vested benefits.

Approximately 3 million employees are covered by plans that are currently underfunded. Many of these plans are funded are less than 90 percent. Many of these plans are underfunded by hundreds of millions of dollars.

Employees who rely on severely underfunded multiemployer plans for their retirement benefits are threatened by continued underfunding. If a plan becomes insolvent, PBGC guarantees $487.50 per month of retirement benefits. This compares unfavorably to the $2,500 per month promised by some of the underfunded plans in the trucking industry.

The problems of employers that arise from multiemployer pension plan underfunding are real. My employer, Leaseway Transportation, is a trucking company with operations throughout the United States. Revenues for 1993 were approximately $630 million. As a result of obligations under our union contracts, Leaseway contributes to more than 40 multiemployer plans. Leaseway's aggregate

contingent withdrawal liabilities to these plans are estimated to be in excess of the company's $50 million net worth.

Although Leaseway does not desire to withdraw from any of the plans in which we participate, events outside of the company's control, such as the cancellation of a major contract, could result in claims that exceed our ability to pay.

Other union trucking companies who are members of our Coalition, particularly the smaller family owned companies are also threatened by their obligations to underfunded pension plans. These obligations make it difficult, if not impossible, for these individuals to reap the benefit of years of hard work and risk.

Potential purchasers are not willing or able to assume contingent liabilities that far exceed the value of the business. In addition, a company's financial results are affected because its pension fund obligations negatively impact credit ratings and interest rates.

The PBGC and the administration have taken the position that the problem of underfunding in multiemployer plans is not so great that Congress needs to address it now. This position is unrealistic. PBGC has admitted that the insolvency of even one large multiemployer plan could threaten the relatively small surplus of the PBGC's multiemployer insurance fund.

Further, in September 1993, the General Accounting Office reported to Congress that the PBGC has not adequately assessed its liability for future assistance to financially troubled multiemployer plans.

The administration's efforts to deal with underfunding in defined benefit plans, as reflected by S. 1780, will be incomplete unless they also deal with underfunding of multiemployer plans. The attention now being given to single employer plan underfunding presents a perfect opportunity for Congress to correct the chronic underfunding in multiemployer plans.

The question of multiemployer pension plan reform is not new. In 1991 and again in 1992 our Coalition testified before House and Senate subcommittees regarding multiemployer pension plan underfunding.

In the last Congress and again in this Congress Senator Jeffords introduced the Pension Funding Improvement Act of 1993. Title II of the Pension Funding Improvement Act includes modest limitations on unfunded benefit increases in certain underfunded single and multiemployer pension plans. This is as Senator Jeffords discussed this morning "the first rule of holes"—if you are in a hole, stop digging.

Our Coalition supports these limitations as a necessary part of comprehensive pension reform. Action should be taken now while the issue of pension funding is being considered by the Congress and before plan reorganizations and insolvencies occur. Employees are entitled to rely on the pension promises that are made to them. Although potential restrictions in unfunded benefit increases might at first glance appear to be unfair, these restrictions are far less unfair to employees than a system that authorizes empty pension promises.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Spira appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Spira, with admirable precision and you add a dimension to this matter which we have not heard. It is part of the Jeffords-Durenberger-Kassenbaum proposal. I see Mr. Barnette nodding. We have to take this into consideration, obviously.

Well, we have heard all divergent views. We have asked Mr. Slate to comment specifically on the testimonies of Mr. Barnette and Mr. Labedz. I am persuaded that there is something we need to do and we need to do it this year. We want to do it carefully.

Senator Packwood?

Senator PACKWOOD. I have a question of Mr. Barnette that does not relate so much to the testimony today as to the facts you gave me when we were visiting. How many employees did Bethlehem have? How many do you have now? How much has it gone down over what period of years?

Mr. BARNETTE. In 1980 we had about 80,000 employees. Today we have 20,000 employees. Today we have 70,000 retirees and 20,000 in the active work force. We have 109,000 plan beneficiaries. We have 170,000 health care beneficiaries—active employees and retirees.

So it is vitally important. We are probably representative of many mature companies who have gone through massive restructuring to become world class, low-cost high quality producers in the products that we have in this market. That is certainly true of our company and it is true of the companies represented by the Coalition. We need to stay competitive and we need internally generated cash to do that.

Senator PACKWOOD. I want to go through these figures.

Mr. BARNETTE. Yes, sir.

Senator PACKWOOD. You have gone from 80,000 employees to 20,000 from 1980 to 1990.

Mr. BARNETTE. Correct.

Senator PACKWOOD. Are you still producing about the same amount of steel?

Mr. BARNETTE. Roughly. That's a part of restructuring, modernization and technology. We have downsized our capability, but we are still very substantial—the second largest steel producer.

Senator PACKWOOD. So your productivity has gone up tremendously.

Mr. BARNETTE. It has gone up by quantum measurements—two to three times depending on the product and the Division.

Senator PACKWOOD. Now you have 20,000 employees, active employees.

Mr. BARNETTE. Yes, sir.

Senator PACKWOOD. And you are covering how many beneficiaries under your health plan?

Mr. BARNETTE. 170,000 health care beneficiaries at a charge to P&L—these are approximate numbers, Senators—of $250 million. And in our case our cash expense of health care and pensions is about the same.

That is why, Senator, we so appreciate the leadership of this committee and, Chairman Moynihan, this committee on health care and other related matters. Health care is a critical issue, but it is related to pensions.

Senator PACKWOOD. Now, 20,000 employees, 170,000 health care beneficiaries.

Mr. BARNETTE. Yes, sir.

Senator PACKWOOD. I am just going to take a guess, what, 60,000 of those are employees and dependents and 110,000 are retirees?

Mr. BARNETTE. Approximately, yes, sir.

Senator PACKWOOD. And those retirees in many cases you are carrying from age 55 onward.

Mr. BARNETTE. Yes.

Senator PACKWOOD. With rather generous health benefits.

Mr. BARNETTE. For some. Some may have other jobs. I think the the pre-Medicare coverage under President Clinton's bill and other bills would have a limited effect because those benefits do not trigger in until such later time so that the retirees would be up in the Medicare age levels anyway. But we do have a substantial number.

Senator PACKWOOD. Say that again.

Mr. BARNETTE. We have employees who have retired early.

Senator PACKWOOD. Right.

Mr. BARNETTE. Employees who are retired as the result of restructured operations.

Senator PACKWOOD. Do you cover them with their health benefits when they retire?

Mr. BARNETTE. We do. We do, indeed.

Senator PACKWOOD. Are they a significant portion of your $250 million cost?

Mr. BARNETTE. They are not.

Senator PACKWOOD. They are not?

Mr. BARNETTE. They are not. They are a portion of that liability. But they may have second employment and they are marching toward the age 62 or 65.

Senator PACKWOOD. And if they have other employment you are not responsible for their health benefits?

Mr. BARNETTE. Normally that would be the case, Senator.

Senator PACKWOOD. If they are covered, if whoever covers, instead of primary payor you are a secondary?

Mr. BARNETTE. Yes, that is correct.

Senator PACKWOOD. Thank you. That is all I have, Mr. Chairman.

The CHAIRMAN. That is a stunning ratio, that from 80,000 employees you are down to 20,000 and you produce just as much steel.

Mr. BARNETTE. Slightly less, Senator. But the order of magnitude is roughly the same.

The CHAIRMAN. That is a phenomenal achievement by the firm and by the work force. But it does produce this extraordinary ratio of active employees to retired employees. That is in one sense good.

Mr. BARNETTE. Yes, it is.

The CHAIRMAN. We are not short of steel. It just represents advances in technology. But as with all that creative destruction of capitalism, it has side effects you have to attend to. But no one comes before us more open about these matters than you, sir.

Mr. BARNETTE. Thank you, sir.

The CHAIRMAN. We much appreciate it.

Senator Pryor?

Senator PRYOR. Yes, sir, thank you, Mr. Chairman.

The CHAIRMAN. The Chairman of our Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service.

Senator PRYOR. Thank you, Mr. Chairman.

I did not want my absence this morning earlier to indicate my lack of interest in this subject, Mr. Chairman.

The CHAIRMAN. We explained.

Senator PRYOR. I had to chair another hearing this morning of the Governmental Affairs Committee. But I want to thank you, Mr. Chairman and Senator Packwood, for holding this hearing.

I just have a couple of questions. First to Mr. Barnette. Let me ask, I think the line of questioning imposed by Senator Packwood is very interesting. Let me continue that with a couple of questions. Does your particular company pay 100 percent of the health care program, the benefits for your employees?

Mr. BARNETTE. It does not, Senator. We have share rings. We have deductibles. We have co-pays. We have a number of different collective bargaining agreements. They may be slightly different under different agreements, but there is a full employee involvement in the health care process now and it varies by employee. It varies by retiree also, depending on when the person retired.

Senator PRYOR. That has gone through some degree of change also in the last few years.

Mr. BARNETTE. Yes, sir, it has; and through good cooperation, especially by the unions, the United Steelworkers, through excellent cooperation by employees. We have active managed care programs. We have a new health clinic in Bethlehem, PA. We are doing a lot of things to try to reduce our own health care expenses and keep the quality of health care up.

Senator PRYOR. Good. Thank you.

Now, the steel, and automobile, airline industry account I guess for a fairly large portion of the estimated underfunding that we are talking about this morning. Now, my question is this, taking your company, how much more can you pay into the unfunded plans or the PBGC, how much more can you pay at this time without jeopardizing your financial position or without cutting back further employees?

Mr. BARNETTE. It is a question of competitiveness, Senator. I think it is an excellent question and it is the very heart of many of our concerns about this legislation. I guess we prefer to use the word "unfunded" rather than underfunded because underfunded suggests we have not done something that by law we are required to do. That is not the case in our company or the members of our Coalition.

But the question is one of competitiveness and what internally generated cash must we have to keep our companies competitive. In the case of Bethlehem in the last 2 years we have contributed $600 million to our pension trust. We have a $1 billion pension funding credit at the present time.

The contributions we are making under current law, Senator Pryor, are ones that could otherwise be used for capital expenditure and modernization. These funding requirements under current law are going from $250 to $500 million. They are going to double under current law going into next year. That is a very substantial increase.

Senator PRYOR. Excuse me. This goes into the unfunded plan?

Mr. BARNETTE. Yes.

Our contribution requirements are going to double under current law, from $250 to $500 million, again, using general numbers. And as with Senator Packwood, with your permission, Mr. Chairman, I would like to file a memorandum with the specific members and the specific responses.

But, yes, sir. So to have that happen and have our premiums triple, this legislation will triple our premiums from about $8 million to $24 million premium payments, would impose very substantial economic consequences on our company.

But we very much want to get our unfunded liability funded and we are doing all we can responsibly and still stay competitive in the industry that we are in.

Senator PRYOR. Well, I want to thank you for that. I did not hear our colleague Senator Jeffords this morning. But it appears that the bottom line of Senator Jeffords concept, I guess, is in looking back over the past history of these pension funds, is that we have been basically borrowing or robbing—he may have said—from the pension funds to pay for health care benefits. I think he had a chart here earlier.

Mr. BARNETTE. Yes, sir.

Senator PRYOR. Do you agree with his hypothesis on this?

Mr. BARNETTE. I would never disagree with a U.S. Senator, Senator Pryor. I agree with his hypothesis that they are increasing. But I must say that in the case of our company, I can best speak, both have been increasing. Our health care expenses are $250 million generally.

Our pension expense is the same and both have been increasing. Health care has increased though expedientially compared to pension expense on a comparative basis.

Senator PRYOR. Mr. Chairman, I just have one more question of Mr. Barnette. I appreciate this.

This is a question that comes from an article in the Wall Street Journal of December 3, 1993. I will quote.

Mr. BARNETTE. Yes, sir.

Senator PRYOR. "... for every 1 percentage point decline in interest rates, you can expect a 20 percent increase in liabilities." Now this is from Ann O'Connell who is a nationally defined benefit business leader for the accounting firm of Coopers & Lybrand.

So now we have a little increase in the interest rates. Does this also mean that the unfunded liabilities is looking a little rosier for us?

Mr. BARNETTE. It does, Senator. Yes, sir, it does. In the case of Bethlehem Steel a decline of 25 percent basis points, a quarter of a percent, increases our unfunded liability by $100 million. One percent means $400 million. The change is that dramatic.

To mandate very conservative interest rates, which we believe are far more conservative than what FASB requires, and certainly does not relate to the actual earnings on our pension fund, would substantially overstate pension liabilities. So it is a key issue to examine both the mortality tables suggested here as well as the interest rate assumptions.

Senator PRYOR. I want to thank you, Mr. Barnette.

Mr. BARNETTE. Yes, sir.

Senator PRYOR. Mr. Chairman, if I might ask your indulgence.

The CHAIRMAN. Please.

Senator PRYOR. I would appreciate very much if you would place my statement in the record. I was going to give it this morning, but I did not have an opportunity.

The CHAIRMAN. I would place it there.

Senator PRYOR. Thank you, sir.

[The prepared statement of Senator Pryor appears in the appendix.]

The CHAIRMAN. It would be interesting to the committee if I could ask that each of our witnesses, and we have one to hear from yet, could give us a sense of what portion of the portfolios involved in a pension system are interest sensitive in the sense that they might be 90-day Treasury bills or things like that. This would help us. Could we ask Mr. Labedz, Mr. Spira, and Mr. Hirschland? 1.

Mr. LABEDZ. It varies from time to time. But I would say that with the investment strategy of pension managers more is in equities than in debt instruments today. But there is still a substantial portion.

The CHAIRMAN. Why don't you give us a note when you can get an approximate answer. Mr. Spira?

Mr. SPIRA. I am afraid I do not have the answer to that.

The CHAIRMAN. No, I did not think you would. But it has come up. Dig it out.

Mr. Hirschland, you all know a lot about those things.

Mr. HIRSCHLAND. I would also instead of try to answer, I would rather send you a note about it.

The CHAIRMAN. Yes. Sure.

Now we have the pleasure of having Ms. Paula Calimafde. Do I have that correct?

Ms. CALIMAFDE. It is Calimafde.

The CHAIRMAN. Just Calimafde, no "ee." I was misinformed. Representing the Small Business Council of America. We welcome you for this final——

STATEMENT OF PAULA A. CALIMAFDE, J.D., CHAIR, SMALL BUSINESS COUNCIL OF AMERICA, BETHESDA, MD

Ms. CALIMAFDE. Thank you very much. It is a pleasure to be here. My name is Paula Calimafde. I am the Chair of the Small Business Council of America. I am also a practicing attorney who specializes in retirement plan and employee benefits law.

I am here only to discuss the miscellaneous provision in this bill which would ban cross-tested and age-weighted defined contribution plans. It is important to understand that this provision deals with defined contribution plans, whereas the whole rest of the bill and everything you have already talked about in large part is dealing with the funding of defined benefit plans.

Now defined contribution plans are just a totally different animal. They have individual account balances. Every participant in the plan knows what his or her account balance is each year by law. Participants are basically either 100 percent vested or vested within a short period of time.

Small businesses that are stable enough to sponsor retirement plans almost never sponsor defined benefit plans. Defined benefit plans simply got too expensive for small businesses.

Defined contribution plans have not caused any of the problems that are going on with PBGC now. There is no PBGC guarantee or funding that PBGC gives defined contribution plans because every year they have to be funded properly or correctly or, fully funded is the best way to put it. So there is no government subsidy, or protection, or guarantee in a defined contribution plan.

The reason why small businesses are so upset about a miscellaneous provision in the PBGC bill is that the Section 401(a)(4) regulations, which are about 600 pages in length, allow defined contribution plans to be tested on a benefits basis as well as a contributions basis.

When you test a defined contribution plan on a benefits basis, it allows the plan to take age into account. What that means is, it is very similar to life insurance. If a company pays $1 for a 30-year-old for $1,000 of life insurance and $10 for a 55-year-old for $1,000 of insurance, it is considered fair because they both have the same $1,000 of insurance.

That is exactly what is going on with the cross tested or age-weighted plan. The contributions going in are different. But if you test them as to what each person would get at retirement age, it would be the same. So older employees receive larger contributions because they have less time to accumulate benefits in the plan until they retire.

I have heard some people say that age-weighted and cross-tested plans are the same as defined benefit plans. Nothing could be further from the truth. There is just almost no similarity between an age-weighted or cross-tested plan and a defined benefit plan. Treasury says, they do not have the protections afforded to a defined benefit plan. Well, the protections afforded by a defined benefit plan are what you are all talking about today, the PBGC guarantee. You do not need that in a defined contribution plan.

Another area where you might say a defined benefit plan is better than a defined contribution plan is that in a defined benefit plan there is an actuarially assumed interest rate. In a defined contribution plan, whatever the account balance earns is what the employee gets.

But there is another major difference that no one is talking about, which is critical to small business employees, which is in a defined benefit plan you get cut back if you don't stay with that company until retirement age. Now unfortunately in the small business arena employees do not tend to stay as long as we would like. Quite often they move into big business.

So what happens is, if you have a plan that has a cut back if you are not there to retirement age, the employees are understandably angry about it and they get less. So if you really sat down and looked at your numbers between a defined benefit plan and an age-weighted or cross-tested plan, you would find that for almost all employees they are going to do better in the age-weighted or cross-tested plan unless they are planning on staying until retirement with that company. Unfortunately, as I said, most small businesses cannot rely on that.

I have heard people say age-weighted plans are abusive. Well, age-weighted plans are not abusive. I think even Treasury would say they know age-weighted plans are abusive. In an age-weighted plan the amount of the contribution depends on what age you are. That is exactly what goes on in target benefit plans and defined benefit plans.

If there is any kind of abuse out there, it would be in the cross-tested area. However, these plans can provide some valuable benefits. For instance, you can have a plan that gives one contribution for people hired before a certain date and people hired after another date—that allows a company to give credit or extra benefit for long-term employees. Another example is giving extra credit to older employees.

Finally, I want to mention that the SBCA is a member of the Coalition to Preserve Profit Sharing Flexibility. NFIB is a member of this Coalition and NAM is a member of this Coalition. The Profit Sharing Council is the head of this coalition. By the way, almost every retirement plan group in the country, save I think two, belong to this Coalition. We are trying to come up with a compromise that is simple.

This is the compromise—to get into the world of cross-testing, as long as a top heavy plan provides 5 percent contribution for every non-highly compensated employee, then the plan will meet the non-abusive rules under 401(a)(4).

We think it is a fair compromise. It hurts us more than most plans because every small business plan is basically top heavy. That is how it works out mathematically. But we are willing to go along with this compromise because it is based on simplicity. We are getting very tired of these incredibly complicated rules.

So that is why we are going along with it. We really like the simple concept and we are willing to deal with some kind of compromise to either have this cloud removed that is in the PBGC legislation or to work out some kind of compromise that we can live with. Thank you.

The CHAIRMAN. We thank you.

[The prepared statement of Ms. Calimafde appears in the appendix.]

The CHAIRMAN. It is refreshing, I believe you are the first attorney I have heard come before this committee and complain about complicated rules.

Ms. CALIMAFDE. Is that right? I could produce a lot for you.

The CHAIRMAN. Attorneys tend to like complicated rules. Their clients may not.

Ms. CALIMAFDE. Not this attorney.

The CHAIRMAN. Good for that attorney. And we are interested, indeed, in your proposition.

Right now we have a question of the equity of tax expenditures. At this point about the top one-fifth of families by income receive three-fifths of the tax expenditures in the pension area and there is a question of fairness. What is it, the bottom two-fifths of families receive 1.5 percent. The bottom 40 percent gets 1.5 percent.

Senator Packwood?

Senator PACKWOOD. No further questions, Mr. Chairman.

The CHAIRMAN. All right, sir.

Senator Pryor?

Senator PRYOR. No questions. Thank you.

The CHAIRMAN. Well, we want to thank our panel. We do very much appreciate it. We would like any comments you have on the interest sensitivity. It would help us get our own minds in shape.

Thanks to all present. You should know we are going into an Executive Session to hear Ms. Valerie Lau who is nominated to be the Inspector General of the Department of the Treasury.

We will stand in recess for 15 seconds for stretching purposes.

[Whereupon, at 12:24 p.m., the hearing was adjourned.]

APPENDIX

Additional Material Submitted

Prepared Statement of Curtis H. Barnette

Thank you, Mr. Chairman. I am Hank Barnette, Chairman of Bethlehem Steel Corporation. I am testifying today on behalf of the Pension Issues Coalition, a group of companies that was recently formed to work together on legislation to reform the Pension Benefit Guaranty Corporation. We appreciate the opportunity you have given us to testify on the Administration's proposed legislation, S. 1780, "The Retirement Protection Act of 1993."

The Pension Issues Coalition represents a broad cross section of American business in industries such as airlines, automobiles, defense, energy and metals. Coalition members operate in highly competitive markets, often with intense foreign competition. Members companies include ALCOA, Armco, Bethlehem Steel Corporation, Chrysler Corporation, Ford Motor Company, General Motors Corporation, Northwest Airlines, Inc. and Westinghouse Electric Corporation. Coalition members sponsor pension plans covering nearly 2 million workers and retirees, backed by over $90 billion in assets.

The Coalition has a vital interest in maintaining the financial integrity of the PBGC. As the Committee well knows, the PBGC is not supported by taxpayers; PBGC is supported by premium payers. Last year, Coalition members paid PBGC $105 million in premiums, about 12 percent of PBGC's total. The Coalition commends the Administration's goal of ensuring a financially sound pension insurance program and its willingness to consider a wide range of views concerning the PBGC. We appreciate the Administration's efforts to tone down the rhetoric about the PBGC's future and we thank Secretary Reich, Executive Director Slate, Assistant Secretary Samuels and their staffs for their leadership. Many members of the Coalition, my company included, have been supportive of the Administration's legislative efforts in many other areas, including health care reform. We believe that certain points in the Administration's bill would be helpful. In particular, we agree with proposals (1) to eliminate tax penalties for funding pension plans, such as the excise tax on contributions in excess of 25% of compensation, and (2) to establish a solvency rule to make sure that pension plans do not run out of cash.

However, there are other provisions in the proposed legislation that we believe would impose unwarranted additional costs and impair our ability to compete. Let me give you some examples.

First, the Administration's proposal would require members of our Coalition to fund pensions to a level that is significantly above the amount necessary to pay all promised benefits. This overfunding is mainly the result of a requirement that plans calculate their liabilities using mandated assumptions about mortality and interest rates that, in fact, are simply wrong for the members of our group. A recent, detailed study by the Society of Actuaries independently confirms that the mortality table mandated by S. 1780 does not reflect the actual experience of companies such as ours. By requiring employers to use actuarial assumptions that overstate pension liabilities, the proposal directly imposes excessive funding costs on employers.

Not only is full-funding redefined by S. 1780, but companies are required to reach this new level very rapidly. The result is a large increase in annual contributions that apply retroactively to benefits that have already been established. Capital-intensive businesses faced with restructuring and severe competition, much of it foreign, will be less able to weather business cycles and make the capital investments necessary to stay competitive. Weaker companies mean fewer jobs, and more importantly for this legislation, weaker companies mean greater risks to the PBGC.

Second, in addition to the new funding requirements, the proposed legislation would impose a premium increase. There is no need for this increase. The PBGC premium has been raised three times in the last decade. For Coalition members, the average increase has been even greater. PBGC premium revenues are now close to $1 billion annually, three times the amount that PBGC needs to pay unfunded guaranteed benefits. This very healthy cash flow stands in sharp contrast to the mid-1980s, when annual premiums were less than PBGC's share of annual benefits.

The main reason—perhaps the only reason—for the proposed premium increase is the need to make the bill "revenue neutral," that is, to offset the additional tax-deductions that would result from the increased pension funding required by the bill. The members of the Coalition disagree with this logic. The new funding requirements included in S. 1780 are supposed to reduce the risk to the PBGC. But, if this were true, PBGC would need less premium revenue, not more.

Third, the Coalition is also concerned with the provisions of S. 1780 that would grant sweeping new oversight and enforcement powers to the PBGC to become involved in the ordinary business affairs and transactions of companies that sponsor so-called "underfunded" pension plans—determined using PBGC's overly conservative measures. The bill would authorize a level of interference in arm's length business transactions that is just not warranted. More pointedly, this government involvement with business would be aimed at the companies that have the greatest need to restructure in order to remain competitive.

Some have argued that a crisis is at hand and Congress must act regardless of these problems. We do not believe there is a crisis. The financial condition of the PBGC is not deteriorating and PBGC will not become the next "S&L" crisis.

The PBGC's deficit is not increasing. Since the mid-1980s, PBGC's total *reported* deficit has grown from $1.5 to $2.9 billion. During that time, however, PBGC changed its accounting methods. In 1989, the PBGC began to count "probable" terminations as part of its current deficit. Probable terminations are pension plans that the PBGC believes will terminate, but have yet to actually terminate. This change in accounting methods does not reflect any underlying change in PBGC's financial condition. But, because of the change, PBGC appears to be worse off. In fact, PBGC's deficit for actual terminations has decreased during this time.

Given the dramatic decline in interest rates over the last few years—a decline that tends to increase PBGC's calculated deficit and individual companies' calculated liabilities—it is a very encouraging sign that the PBGC deficit has not risen more sharply. The PBGC has also changed its mortality assumptions twice, and both times the result was an increase in measured but not actual liabilities. When PBGC's deficit is computed the same way each year using the same assumptions and accounting conventions, the only conclusion that can be drawn is not that something is going wrong, but rather, that something is going right.

The Coalition has also examined the trend in the funding level of the pension plans that PBGC insures. According to PBGC, pension plan underfunding has nearly doubled over the past six years to $53 billion. The Administration frequently cites this $53 billion figure to justify immediate action. But, upon closer examination, we found no cause for alarm.

Let's look at the $15 billion growth in underfunding that occurred between the last two surveys years—which accounts for almost 60 percent of the "doubling" cited by PBGC. What is not reported is that (according to PBGC's Top-50 list) while liabilities of underfunded plans grew by 28 percent from 1991 to 1992, assets also grew by 28 percent. The result is that the pension plan's funded ratio—the percent of liabilities that is funded—remained constant. There was no alarming deterioration in funding. The reason for the apparent growth in underfunding is that PBGC used a much lower interest rate than it has in years past to estimate its liabilities. PBGC itself has acknowledged that "the primary reason for the increases in underfunding was the fall of interest rates to historically low levels." What has not been pointed out is that interest rates have increased recently, which would drive down underfunding by PBGC's own measure. Unfortunately, this will not be reported for another year and a half because the PBGC list is based on old data. It is difficult to understand why action must be taken now to address the growing underfunding that is a result of past decreases in interest rates which have now begun to increase.

It should also be noted that there have been significant changes in the legal and accounting environment that have gone largely unrecognized in the debate over PBGC reform. Since 1986, it has become much more expensive for companies to maintain pension plans that are not fully funded. Companies are now required to recognize unfunded obligations on their balance sheets. Another important change has been the reaction of creditors to companies with pension underfunding. Creditors and the rating agencies now treat pension liabilities like any other debt. In gen-

eral, companies with unfunded pension liabilities receive lower credit ratings and must pay more to borrow. This heightened creditor concern is due to new laws that this Committee was instrumental in enacting in 1986 and 1987. The PBGC now has a claim for the full amount of underfunding and creditors have become very aware that an underfunded pension plan can result in very low recoveries for them in bankruptcy.

In response to these changes, many members of the Coalition are taking extraordinary steps to fund their pensions. For example:

- Since the beginning of 1993, Chrysler has contributed more than $3.8 billion above the legal minimums to its pension plans. The company has also announced its intention to fully fund its pension liability (on a FASB basis) by the end of 1994.
- General Motors recently announced a plan that could lead to a contribution of stock and cash worth approximately $10 billion above the legal minimums to its hourly pension plan.
- Stock offerings in 1993 and 1994 by Bethlehem Steel along with internally generated cash have resulted in an additional $632 million dollars being contributed to its plans.
- Westinghouse has announced its intention to contribute an additional $200 million in stock to its pension plan.

The Pension Issues Coalition wants constructive reform of the PBGC. Indeed, there are several provisions in the Administration's proposal that we support. Even so, the members of the Coalition believe that other provisions of S. 1780 that we have discussed would impair the competitiveness of our companies and the welfare of our employees and retirees.

Thank you, Mr. Chairman. I would be pleased to answer any questions.

Prepared Statement of Paula A. Calimafde

Mr. Chairman and Members of the Committee, I am Paula Calimafde, the Chair of the Small Business Council of America (SBCA). I am also a practicing attorney who specializes in retirement plan and employee benefits law. As Chair of the SBCA, I am here to present our views on the Administration's proposal to ban age-weighted and other cross-tested defined contribution plans which is included in the Administration's PBGC reform proposal (S. 1780). This testimony is also endorsed by the Coalition for Profit Sharing Flexibility, which is chaired by the Profit Sharing Council of America and includes NFIB and NAM as members. All members are listed below.

SBCA is a national nonprofit organization which represents the interest of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans.

As a spokesman for small business retirement plan sponsors, we are primarily concerned with defined contribution plans since they are the preferred retirement plan vehicle for privately held businesses. Unfortunately, they are primarily preferred because defined benefit plans have become too expensive for most small businesses to sponsor. Changes made by Congress over the last ten years dealing with funding corridors and cut backs in benefits, combined with an IRS audit program targeting only small business defined benefit plans which challenged mainstream actuarial assumptions retroactively have effectively closed down these plans. Any practitioner in this area will tell you that the demise of the defined benefit plan occurred well ahead of the time that the Section 401(a)(4) regulations were even issued the first time in proposed format. It is foolish to think of these plans as somehow "replacements" for defined benefit plans and therefore hurting the PBGC fisc. At the same time to talk about these plans not having the "protections" afforded defined benefit plans is also an absurdity since they must be funded on a current basis and generally credit the same if not better interest yields to participants than defined benefit plans. Also, for most small business employees, specifically including non-highly compensated employees, these plans provide for larger contributions amounts, which are vested in a short period of time, if not immediately, and most importantly are not subject to the "accrued benefit" fraction which cuts back employees if they do not stay with the company until retirement. Almost any non-highly compensated small business employee will receive more under ANY cross-tested plan than a defined benefit plan. Accordingly, we do not offer recommendations on the proposed modifications to the PBGC insurance program. We limit our remarks to the proposed ban on age weighted and other cross tested defined contribution

plans which by law are totally outside the PBGC program and do not contribute in any way to the PBGC's financial problems. We do not believe that changes to defined contribution plans should be included in a bill aimed exclusively at protecting the interests of employees covered by defined benefit plans.

We are opposed to this proposal to ban age-weighted and other cross-tested plans. Small businesses overwhelmingly rely on defined contribution plans to meet the retirement needs of their workers. Many use age and service weighted plan formulas which benefit all employees, both highly compensated and non-highly compensated employees, but would be outlawed by the Administration's proposal.

The SBCA believes that employers should be able to continue sponsoring age-weighted and other cross-tested defined contribution plans. We do not share the Treasury view. By its own admission the Department has no hard evidence that these plans are being utilized in an abusive manner (indeed plan sponsors are following IRS regulations) and has allowed that its proposed ban of all cross-tested age weighted plans is not warranted.

First, it must be understood that age-weighted plans are simply not abusive. The hundreds of technical experts in the SBCA have never seen any abusive situations under these types of plans. The protections designed by the IRS through its regulations, combined with the top-heavy minimum requirements, assure that the interests of all employees are fully protected. In fact, any practitioner skilled in the retirement plan area will quickly concede that the age-weighted plan will give rise to almost identical numbers as a target benefit plan and similar, if not larger numbers for non-highly compensated employees, than those generated by a defined benefit plan.

IRS Code §401(a)(4) prohibits discrimination in favor of highly compensated employees. This section provides that either contributions or benefits must not discriminate in favor of highly compensated employees. Age-weighted and cross-tested plans comply with IRS developed non-discrimination regulations which were developed over a period of five years. These regulations received significant analysis and input and were drafted, proposed and re-proposed several times before being finalized in the fall of 1993.

Testing contributions on a benefits basis allows age to be taken into account. A smaller contribution for a younger employee will provide the same retirement benefit when projected to retirement age as a larger contribution for an older employee. The smaller contribution has more time to grow, so that when projected to retirement age it is equal or greater in value to the larger contribution made for the older employee, which has less time to grow. Thus, when contributions are compared by the retirement benefit they are projected to provide, a smaller contribution for a younger employee is nondiscriminatory. The fact that a contribution was greater for an older person does not mean that the plan discriminated against a younger employee. A simple analogy which involves group life insurance may help explain the process. A $1,000 death benefit may cost an employer $1.00a year for a 30 year old. The same $1,000 death benefit may cost the employer about $10.00 for a 57 year old. The fact that the employer is paying as much as ten times more for the older person does not make the plan discriminatory. The plan is absolutely non-discriminatory because it provides the same benefit to each employee. So it is with cross-tested qualified plans. When the benefit provided is the same, the plan is not discriminatory, even though the current year's cost is different.

If there are discriminatory cross-tested plans, then the correct solution is to provide that all employees receive some threshold contribution rather than prevent employers from using a plan technique that has made it possible and feasible for many small businesses to offer a retirement plan. While curbing abusive tax practices is a legitimate objective, as or more important are the objectives of fostering coverage and providing retirement income and long term savings. Micromanagement and additional changes in the law are counterproductive to these desirable goals.

It is the experience of SBCA's practitioner members that where it is possible to design cross-tested plans to result in wide disparities between highly and non-highly compensated employees, most employers are unwilling to adopt such a plan, since to do would be counterproductive to the goal of providing a valuable and appreciated employee benefit. Because the plans are used not only to provide a vehicle for significant retirement savings, but also to provide a legitimate and valuable employee benefit, absent a dire downturn in profits, contributions for employees should stay at current levels or be increased. The existing rules work quite well to achieve that result.

Recent examples of actual cross-tested plans show how desirable these plans can be. A high technology company which produces software has just become stable enough to provide retirement benefits for its employees. The company started in 1984. The company did not want to become involved with a defined benefit plan be-

cause of the high administrative and actuarial expense involved. At the same time it wanted to benefit its loyal long term employees particularly because loyalty is not a given in this industry. The company adopted a cross-tested plan which had two groups—employees hired before 1986 and those hired after 1986. The employees hired before 1986 received a 14% contribution, those hired after received a 7% contribution. This plan suited the goals of the company and all employees received a significant retirement benefit they had not received before.

Another company, a large incorporated law firm, set up three different groups—the first for all employees who are over the age of 50, the second group for employees except associate attorneys who are under the age of 50 and the third group for associate attorneys who are under the age of 50. The first group is to receive a 12% contribution, the second group is to receive an 8% contribution and the final group receives a 3% contribution. Again, this plan suited this company better than any other type of plan available to it. This plan is certainly not abusive.

There are many options available to companies who are willing to come under the auspices of the 401(a)(4) regulations. For instance, different divisions can be given different plan formulas, different groupings of employees, based on service, age or type of job, can be given varying percentages, additional contributions can be given to employees who exceed certain production goals, etc., etc.—as long as the complex, and carefully constructed guidelines of the 401(a)(4) regulations are followed. These are decent goals and their use should not be curtailed by a reaction that only defined benefit and target benefit plans should be allowed to assist older employees.

While Treasury Department officials have admitted that the proposed ban was an over-reaction, the dilemma they created continues to work a severe hardship on small plan sponsors who have elected to use an age or service weighted benefit formula. It has also dissuaded or discouraged many potential small business plan sponsors from adopting a retirement plan that gives credit to age or service.

Defined benefit plans which by their very terms assist older employees, realistically cannot be sponsored by small business. Many companies, particularly mid-size or smaller, who would provide larger benefits for their older employees, now shy away from defined benefit plans. Among the reasons are extraordinarily high administrative costs and complexity. These additional burdens and complexity have been added by Congress and IRS over the last ten years.

Therefore, our request of the Senate Finance Committee is to work with cross-tested plan sponsors to help convince the Administration to either officially abandon the repeal of the age-weighted and cross tested plans, or agree upon a mutually agreeable alternative for curbing aggressive use of cross-testing plans.

The Coalition for Profit Sharing Flexibility has come up with a compromise which is fair and simple, which we endorse wholeheartedly. The SBCA is a member of the Coalition for Profit Sharing Flexibility which literally includes every major retirement plan group save ERIC (The ERISA Industry Committee) and APPWP (Association of Private Pension and Welfare Plans). Other members of the Coalition include: the Profit Sharing Council of America (Coalition Chair); the American Council of Life Insurance (ACLI); the American Society of Pension Actuaries (ASPA), the Association for Advanced Life Underwriting (AALU); the Employee Benefits Policy Association; the Employers Council on Flexible Compensation (ECFC); the National Association of Life Underwriters (NALU); the National Association of Manufacturers (NAM); the National Federation of Independent Business (NFIB); the National Institute of Pension Administrators (NIPA); and the U.S. Chamber of Commerce.

This coalition has come up with a fair and workable compromise. This is the only compromise to date which is based upon simplicity. The importance of simplicity in this area can no longer be ignored. Unfortunately, SBCA has reviewed two other proposals which have been advanced by groups which protect the interests of large employers—both of these proposals suffer from the same fatal flaw—they are indecipherable.

As mentioned above, the final IRS regulations clearly endorsed the "age-weighted" and other "cross-tested" plans and set forth a road map for companies to follow so as to demonstrate nondiscrimination. Over the last four years, these regulations have been issued in proposed, final, re-proposed, and finally, final form with the IRS and Treasury being fully aware of these provisions and how they operate. At each stage the rules for testing nondiscrimination on a benefits basis have remained essentially the same.

A senior Treasury Official criticized these plans at a press hearing held on September 30 1993 and proposed eliminating them. This same official had signed off on these 401(a)(4) regulations which explicitly allow age-weighted and cross-tested plans, less than a month before. Indeed, two days before the press statement criticizing the plans, IRS had announced that it would begin approving individually 'designed age-weighted and other cross-tested plans (September 28, 1993). The PBGC

legislation because it included language prohibiting these plans thus came as a major surprise, particularly to practitioners who had relied on the regulations and the many oral statements of senior IRS and Treasury Officials made at practitioner continuing legal education conferences explaining how these regulations worked.

This legislation provides that defined contribution plans (other than target benefit plans) can only be tested for nondiscrimination on the basis of contributions and not benefits. The effective date for this ban on these plan is for plan years beginning after September 30, 1993, except for plans that were in existence on that date, the effective date is for plan years beginning in 1995. Questions still remain as to the meaning of the effective date.

Privately held companies who had adopted these individually designed plans discovered that what had been set forth by the regulations for more than four years had within a matter of days been deemed "abusive" and legislation had been introduced to eliminate the newly established plans. Understandably, companies large and small which had paid money to advisors to establish these plans and/or work out the numbers to make sure they fell within the parameters of the legislation are extremely concerned.

The Coalition compromise requires a top-heavy plan that is using the 401(a)(4) regulations to test a defined contribution plan for nondiscrimination on a benefits basis to give a minimum 5% contribution to any non-highly compensated employee. Now this compromise is not perfect, particularly because it singles out businesses which are privately held for greater burdens by requiring extra contributions for those who fall within the top-heavy rules. And there is no question that a hike from 3% to 5% is a major price to pay to enter the world of the 401(a)(4) regulations, particularly when larger businesses have no such road blocks. But despite these real criticisms, this is a compromise that the Coalition can endorse primarily because of its inherent simplicity and fairness which must now begin to reign supreme in the retirement plan area.

SBCA believes that this compromise should only apply to cross-tested plans that are not age-weighted. It is essential to understand that the top-heavy rules already single out small businesses for additional burdens and required minimum contributions. Whether all of these additional requirements are necessary in a system which is driven by the owners of a business wanting to maximize contributions so that there is sufficient retirement income is debatable. Whatever the reasons, the small business plan is almost always more generous than its counterpart in the big business arena.

Last year, the National Institute on Aging (NIA) reported that millions of Americans in their 50s face an uncertain future, lacking health insurance or pensions, or fearing that they will lose the benefits they do have. The survey by NIA found that a substantial number of people—especially minorities—lack pension coverage that may rob them of a satisfying and successful retirement.

The findings, while shocking, do not' come as a surprise to benefits professionals. Most of us are aware that in recent years the focus of America's retirement and employee benefits policy has shifted dramatically for the worse. Those of us concerned about the viability of the private benefits system know all too well that the budget deficit and not retirement and savings objectives, has driven almost all debate on important national issues, including retirement matters.

In March of 1993, the American Academy of Actuaries reported that since 1988 at least 50,000 of America's small business firms—those with less than 25 employees—have eliminated their defined benefit pension plans leaving their workers without retirement plans. An equal number of small firms, according to the Academy, chose to replace their defined benefit plan with a defined contribution plan. The Academy's data is confirmed by the U.S. Department of Labor which reported in its initial *Private Pension Bulletin* that defined benefit plans had decreased by 24% between 1983 and 1989. The DOL reported that the trend shows that we are no longer seeing a growth in the number of plans nor is the percentage of the workforce with pension plans growing. Indeed, while the workforce grows, the percentage of covered workers falls (albeit, there was a small increase in 1992).

This drop in pension plan coverage could not come at a worse time. The graying of America, and the burden that it will place on future generations, can not be ignored. The American Council of Life Insurance reports that from 1990 to 2025, the percentage of Americans over 65 years of age will increase by 49%. This jump in our elderly population signals potentially critical problems for Social Security, Medicare and our Nation's programs designed to serve the aged:

While we must assure our citizens that Social Security and Medicare will remain strong and stable, private pensions, savings and private sources for retiree health care will have to play a more significant role for tomorrow's retirees. The savings that will accumulate for meeting this need will contribute to the pool of investible

capital that will provide the economic growth needed to finance the growing burdens of Social Security and Medicare. But such savings will not be forthcoming in the face of the kind of policy directions reflected by the Administration proposal.

While many factors can be cited for the crisis, two stand out—DIMINISHING TAX INCENTIVES and INCREASED COSTS DUE TO OVERREGULATION. The loss of tax incentives appears to be directly related to our nation's budget deficit problems. Reducing the tax incentives for pensions is destructive of our goal of having an adequate retirement savings system.

Frequently, the case for reducing the incentive is premised on dubious assumptions that the current incentives are not functioning as expected. Oftentimes, advocates for reducing tax incentives employ the politics of envy. Both the Association of Private Pension Plans and the Employee Benefits Research Institute have recently published treatises that punch holes in the logic of those advocating reduced tax incentives for retirement savings. While defending current tax incentives is commendable, what's really needed are new tax incentives to overcome the losses of the past decade.

We are not advocating that pension and employee benefit tax incentives should be designated as too sacred to touch. What concerns us is that the review and evaluations are hasty and seldom subject to adequate public input. Efforts to raise opposing views are subjected to budgetary points of order and saddled with the burden of proposing alternative revenue sources if the questioned policy change is to be removed from the revenue package. This violates the American sense of fair play. We ask simply that someone speak out against what we see as a patently biased approach to setting public policy.

The other factor that is contributing to the stagnation of private pension and welfare plans is the unrelenting drive to suffocate our private benefits system with questionable costs due to increased burdens imposed by regulation. In the above mentioned American Academy of Actuaries study the reason most given for abandoning a pension was the growing burden to comply with government regulation. Nearly 60% of small employers in the Academy's cited the cost of compliance as the primary reason for their decision to terminate a defined benefit plan. Almost 30% of large firms cited this factor also.

Despite the increasing evidence that we are drowning employers in regulations, the push for more regulations and laws appears unrelenting while the drive to simplify compliance is locked up in legislative stalemate as is the case for the laudable Pension Simplification Bill.

The SBCA hopes that the Committee will appreciate the valuable contributions which can be made to our society by allowing the age-weighted and cross-tested plans to flourish and will either legislatively endorse the compromise set forth by the Coalition for Profit Sharing Flexibility or abandon this ill-conceived ban on age-weighted and cross-tested plans entirely.

Prepared Statement of David G. Hirschland

Mr. Chairman, my name is David G. Hirschland. I am the Assistant Director of the Social Security Department of the International Union, United Automobile, Aerospace, & Agricultural Implement Workers of America (UAW). The UAW represents 1.4 million active and retired members of the UAW, most of whom are covered by defined benefit pension plans. We thank you for the opportunity to testify on the subject of the proposed Retirement Protection Act of 1993 (S. 1780) and the problems associated with pension plans that are less than fully funded.

The UAW commends the Administration for its careful review of the financial status of pension funds and the Pension Benefit Guaranty Corporation (PBGC), and the security of the retirement income protection afforded American workers. We agree with the Administration that there is no immediate crisis facing the PBGC. At the same time, we also agree with the Administration that there are longer term concerns that can and should be resolved now.

The legislation which has been developed by the Administration, the proposed Retirement Protection Act of 1993 (S. 1780), focuses on strengthening the funding rules for pension plans. In our judgment, this is the best way to address the problem of "underfunded" pension plans. Improving the funded status of pensions directly improves the retirement income security of plan participants and also helps to protect the PBGC. The UAW applauds the Administration for taking this positive approach, rather than an approach which would cut benefit guarantees or restrict benefit increases.

The UAW strongly opposes proposals others have made to cut the PBGC benefit guarantees, such as by lengthening the phase-in period for the guarantees or elimi-

nating the guarantee for plant closing benefits. And we also strenuously oppose proposals that would restrict benefit increases by encumbering corporate assets. Such proposals would penalize workers and retirees by reducing the security and adequacy of their retirement income. As a result, these proposals are at odds with the central goals of the Employee Retirement Income Security Act of 1974 (ERISA). In contrast, the solution advocated by the Administration—requiring quicker, more secure funding of pension plans—is fully consistent with the goals of ERISA.

The problem of "underfunding" in certain pension plans has not been caused by overly generous PBGC guarantees. Under current law, there are already limits on the amount of benefits which are guaranteed. More importantly, the five year phase-in of the guarantees provides adequate protection against so-called "deathbed" benefit increases shortly before a plan termination. Due to the five year phase-in of the guarantees, companies and unions cannot "conspire" to increase benefits and then dump the unfunded liabilities onto the PBGC. Thus, there is no need to change the existing PBGC benefit guarantees.

Similarly, the problem of "underfunding" has not been caused by inappropriate or excessive benefit increases. While the pension plans negotiated by the UAW with the Big Three auto companies are currently less than fully funded, over the last two decades the benefits provided by the plans have continued to replace a relatively constant percentage of pre-retirement income. The lifetime benefits for our longer service Big Three retirees have ranged around thirty percent of pre-retirement income. And, the total "thirty-and-out" benefit provided to early retirees not yet eligible for Social Security (which includes a temporary supplement, as well as a lifetime benefit) has typically replaced between 50 and 60 percent of pre-retirement earnings.

The reason there has been so much misunderstanding is due in large part, we believe, to confusion over the difference between salary related plans and flat dollar plans. Most pension plans, including the plans maintained by the Big Three auto companies for their management employees, provide pension benefits equal to a set percentage of the wages or salary of the plan participants. Thus, as salaries grow over time (due to inflation or real increases), the amount of pension benefits provided under these plans increase automatically. There is no need to amend the plans every few years to update the benefit levels. Due to the salary-related formulas which are used to calculate benefit levels, this happens automatically.

Unfortunately, the UAW has never been able to negotiate salary-related benefit formulas in plans which cover rank-and-file workers. Instead, these plans (including the plans maintained by the Big Three auto companies for UAW members) calculate benefits based on a flat dollar amount for each of the worker's years of service with the company. As a result, the pension benefits provided under these plans do not automatically rise with the growth in wages (due to inflation or real increases). Instead, the plans have to be amended every few years to adjust the benefit levels to keep pace with the growth in wages. Without these ad hoc increases, the real value of the pension benefits gradually erodes over time, as they replace a lower and lower percentage of the pre-retirement earnings of workers.

Thus, the criticism which has been directed at the benefit increases negotiated by the UAW with the Big Three auto companies is unfair. These increases have not been excessive or irresponsible. They have simply updated the benefit levels to keep pace with the growth in wages, so that the real purchasing power of the pension benefits has not been eroded. These ad hoc benefit increases have simply accomplished the same result that happens automatically under management pension plans.

Proposals that would restrict ad hoc increases in flat dollar plans, such as requiring corporations to put up collateral for these increases, would discriminate against rank-and-file blue collar workers. In effect blue collar workers would be condemned to a decreasing standard of living in retirement. It is worth noting that supporters of these proposals have never suggested that collateral requirements or other restrictions should be applied to the automatic benefit increases which occur under salary-related plans covering management personnel. This amounts to a double standard, and underscores the unfairness of imposing such restrictions on ad hoc increases in flat dollar pension plans covering blue collar workers.

In addition to negotiating ad hoc increases that maintain the purchasing power of pension benefits for rank and file workers, in recent years the UAW has also been forced to negotiate special early retirement programs to assist in the downsizing of the Big Three auto companies. Again, these programs have not been excessive or irresponsible. It is widely recognized that pension plans play an essential role in responsible and humane efforts to downsize a workforce. Many other companies have instituted similar programs. Congress recently approved such a buyout program to help reduce the federal workforce. If the UAW had not negotiated these special early

retirement programs at the Big Three auto companies, thousands of younger workers would have been laid off, resulting in untold human misery and dramatically increasing the costs to federal, state and local governments in unemployment and welfare benefits. The efforts of the Big Three auto companies to reorganize would have been severely hampered, thereby jeopardizing the jobs of the remaining workers. Thus, it clearly does not make sense to restrict or prohibit the types of special early retirement programs which have been negotiated by the UAW.

If the problem of "underfunding" in certain pension plans has not been caused by excessive or irresponsible benefit increases, and has not been caused by the PBGC guarantees, what is the culprit? The answer is really very simple. The inescapable truth is that these pension plans are not fully funded because the companies have not contributed sufficient monies to the plans. Thus, the obvious solution is for Congress to enact legislation requiring quicker, more secure funding of these plans.

There are a number of reasons why these pension plans have not been fully funded. Many of the companies which sponsor these "underfunded" plans have been experiencing severe financial difficulties as a result of the misguided trade and economic policies of the previous Administrations. As a result, they have not always been in a position to aggressively fund their pension plans. At the same time, as these companies have been forced to downsize, the ratio of retirees to active workers and the average age of the active workforce have both substantially increased. This has resulted in higher pension liabilities. Compounding these difficulties is the fact that many of these same companies also face enormous liabilities for retiree health care benefits—liabilities which place them at a disadvantage with foreign and domestic competitors.

The UAW is pleased that the Clinton Administration has taken steps to address these underlying problems. The economic and budget policies of the Administration have provided a basis for renewed economic growth. We are hopeful that the Administration's trade initiatives with Japan will alleviate our longstanding trade imbalance with that country, especially in the automotive sector. In addition, the national health care reform plan developed by the Administration promises to provide health security to all Americans, while at the same time relieving the unfair competitive disadvantage currently suffered by the Big Three auto companies with respect to health care costs. The combination of all of these initiatives can play a powerful role in enabling the Big Three auto companies and other employers to provide better funding for their pension plans.

Contrary to the suggestions of some observers, there has never been any understanding between the UAW and the Big Three auto companies to leave our pension plans "underfunded." In order to establish the principle that pension plans should be pre-funded, rather than being operated on a pay-as-you-go basis, the UAW struck Chrysler in 1950 for over 100 days. Furthermore, we strongly supported the enactment of ERISA's minimum funding standards in 1974; and we then worked to tighten these funding standards in 1987 when the OBRA changes were enacted.

Recently, each of the Big Three auto companies has taken steps to contribute substantially more than the amounts required under ERISA. In 1993, Chrysler contributed over $2.0 billion to its pension plans for UAW members and has contributed almost $1 billion so far in 1994. Chrysler has also announced its intention to fully fund its pension liabilities, on the accounting basis, by the end of 1994. During 1992, Ford contributed $1.4 billion to its UAW-hourly pension- plan; in 1993, they contributed $700 million, and so far in 1994, they have contributed another $700 million. General Motors is presently moving to improve the funding of its pension plan. Its Board of Directors has approved an aggressive funding approach whereby the Company expects to make their plans fully funded by the year 2000. A welcome step towards this goal is their recent announcement of a $10 billion contribution of stock and cash to the hourly plan in addition to the $1.9 billion contribution already made in 1994. The UAW has welcomed these voluntary efforts to improve the funded status of our plans.

Nevertheless, the UAW believes there is still a need to enact changes in ERISA's minimum funding standards to require companies with "underfunded" pension plans to gradually improve the funded status of those plans over a reasonable period of time. Only through legislation can we be assured that necessary contributions will be made. That is why we are pleased the Administration has endorsed this approach in the Retirement Protection Act of 1993 (S. 1780).

The UAW supports a number of specific reforms to strengthen ERISA's funding rules and improve the funded status of pension plans. Specifically, we support tightening the Deficit Reduction Contribution required under OBRA '87 to assure that a plan's funded status actually improves. In this regard, we believe:

1. The double counting of gains and losses in the Funding Standard Account and in the Deficit Reduction Contribution calculations must be eliminated;

2. Actuarial assumptions and interest rates should be required to be responsive to standards that reflect actual plan performance and market conditions, so they cannot be used as tools to minimize required contributions;

3. The Deficit Reduction Contribution formula must also be strengthened in order to move plans more quickly toward a fully-funded position; and,

4. Plan sponsors should be required to recognize for funding purposes any benefit increases that have been negotiated, even if they have not yet become effective under a collective bargaining agreement.

The UAW also believes that some transition rules are needed to make sure that the tougher funding rules do not jeopardize the economic viability of some companies. We are pleased that the Administration has included a transition rule in (S 1780). But we are concerned about the application of the Administration's transition rule to future increases in pension liabilities. These increases may result, for example, from poor investment performance or significant reductions in the interest rate used for valuing current liabilities. Regardless of the reason for the increased liabilities, under the Administration's transition rule, these additional liabilities can lead to dramatic swings in the amount of contributions which a company is required to make from one year to another. This would make it more difficult for a company to meet its pension obligations, and could aggravate the company's financial difficulties.

The UAW believes that the strengthened funding rules should provide for a relatively stable and predictable funding requirement. This can be accomplished by permitting sudden changes in current liabilities, which occur in any year, to be funded over three years; that is, to be phased-in to the targeted funding percentage over three years. This will increase the funded status of the plan to the same position it would have reached over the three year period under the Administration's approach, but with a leveling of the contributions required in any given year as a result of the increased liability. Our proposal would reduce dramatic fluctuations in required funding, without diminishing appreciably the movement of a plan to a more fully funded position.

The UAW also supports the enactment of a plan solvency rule that will assure that underfunded plans are able to pay promised benefits even as they improve their funded status. It makes sense to require a plan to maintain liquid assets equal to expected near-term benefits and other plan obligations.

The UAW strongly opposes the provision in the Administration's bill which would increase the variable rate premium by phasing out the cap. If enacted, this change would place a substantial additional financial burden on companies. Instead of requiring companies with underfunded plans to pay additional premiums to the PBGC, the UAW believes it would be preferable to have these funds go into pension plans directly.

We understand that the Administration has proposed an increase in the variable rate premium in order to offset the "revenue loss" associated with the tougher funding rules and to make the overall bill revenue neutral. The UAW urges Congress not to let the arcane rules of budget scoring force bad policy. Either some other revenue source should be found, or the entire bill should be exempted from the normal budget rules. Since the tougher funding rules will help to protect the PBGC from additional unfunded pension liabilities, they should not be scored as revenue losers. The Administration should not be required to find revenue sources to offset these prudent funding proposals.

With respect to the other provisions in the Administration's bill, the UAW believes the PBGC should have advance notice of reportable events which could threaten a plan's funding or viability. We also support giving PBGC the authority to challenge corporate transactions which could undermine the adequacy of plan funding.

The PBGC has raised concerns over increases in benefits to participants while a corporation is in bankruptcy. The UAW believes it is unduly harsh to prohibit benefit increases in this situation. Current law protects the PBGC because these benefit increases are phased-in over a period of up to five years. Furthermore, a total prohibition on benefit increases would deny increases to workers employed by healthy businesses, which find themselves in bankruptcy only because of the insolvency of a sister corporation. Finally, benefits in management pension plans that are salary-related would be automatically increased if any pay raises are granted during the bankruptcy process. Thus, the proposal unfairly discriminates against blue collar workers whose benefits are typically provided through flat dollar plans.

We are in agreement that the PBGC should have more timely access to financial information dealing with both plan sponsors themselves and their pension plans. The information should pertain to certain cases of severe plan underfunding, or cases involving significant amounts of missed or waived contributions. In addition,

we believe that the PBGC should have authority to enforce minimum funding standards in PBGC-covered plans. We also support measures requiring plan sponsors to inform participants when a plan is "underfunded," and to advise them that there are limits to the guarantees provided by the PBGC. However, we are concerned that the implementation of the notice procedure should be handled carefully so as not to cause undue panic among covered participants.

There are two additional items not covered by the Administration's bill which the UAW believes should be addressed by Congress in any pension legislation. First, the PBGC has argued that the Pension Protection Act of 1987 curtailed the rights of participants and their representatives in recovering non-guaranteed benefits in the event of a plan termination. In at least one reported case, the PBGC prevailed in that argument and participants there were prevented from asserting contractual claims for non-guaranteed benefits. We believe Congress should clarify the right of plan participants and their representatives to assert claims for non-guaranteed benefits they often lose in many underfunded plan terminations.

Second, Title IV of ERISA requires the PBGC to guarantee pension benefits of defined benefit pension plans. Under a previous Administration, the PBGC took the position that when the liabilities for these benefits have been provided for by the purchase of annuities from an insurance company, the agency no longer is responsible for these benefits. The UAW believes this position is directly contrary to the intent of Congress when it enacted the Single Employer Pension Plan Amendments Act of 1986. If this erroneous interpretation by the PBGC is not corrected, the security of pensions, as required by Title IV, would be drastically eroded. We urge you to reassert the PBGC's role in guaranteeing pension benefits regardless of the institution that is paying the benefits to retirees and their surviving spouses.

In conclusion, Mr. Chairman, the UAW appreciates the opportunity to testify on the subject of the Retirement Protection Act of 1993 (S. 1780). We are firmly committed to the objective of improving the funded status of pension plans. We look forward to working with you and the other Members of this Committee as you consider this critically important issue. Thank you.

Prepared Statement of James M. Jeffords

It is a pleasure to come before you Mr. Chairman, as well as the other distinguished members of this Committee to testify about the problems confronting the defined-benefit pension system and the Pens ion Benefit Guaranty Corporation (PBGC). I commend you for your interest in this issue. As you know, there is not a huge popular interest in PBGC reform. But there are tremendously important public policy implications for the retirement income security of all Americans. I don't need to remind you that the Social Security system was never intended to be the total financing package for everyone's retirement. The Social Security system was based on the theory that it was but one leg of a three legged stool—the other two legs were private pensions and individual savings.

Before I share with you my own view of the problem and my recommended solutions I would like to highlight a major fact that seems to have escaped our thoughtful debate on health care reform. As you know the Labor Committee has just completed three weeks of debate and deliberations and was the first full committee to report out a bill. Mr. Chairman, as your Committee works to produce a health care bill I hope you will keep the following point at the forefront of why it is essential to pass health care reform this year.

Mr. Chairman, I'd like you to take a look at the graphs I have brought with me. I have been very concerned about the trend many employers have taken in either underfunding pension plans or terminating them completely. My theory has been that employers are spending so much money on providing health care benefits—there is not enough money in the coffers to provide for their employees retirement income. Thus, many employers are making benefit promises they can never keep—knowing that the Federal government will save the day. At my request, the Employee Benefit Research Institute put together the data for these charts. As you can see, in 1965 private employers were actually putting slightly more money into pension benefits than health benefits—by a ratio of 56% to 44%. But by 1991, the ratio dramatically turned to 79% for health and only 21% for pensions. Interestingly, the public sector, of which we are a part, has continued to fund for employee retirement. As an additional note, as private pension funding has taken a nose dive people are actually living longer. The average life expectancy for men in 1965 was 67 years—in 1991 it was 72 years. For women, 74 years and 79 years respectively.

As a leader in the Social Security trust fund debates I know that you are as concerned as I am about the financial security of older Americans. As the baby-boomers

hit retirement age we will soon only have a two-to-one ratio of people paying into Social Security versus people on Social Security. As if Social Security problems were not enough—this trend of dramatic reductions in private employer spending on pension benefits emphasizes the retirement income crisis our country will face in the next ten to twenty years if nothing is done. We need to make sure that in solving the health care problem we don't rob the pension bank or else we are going to have lots of old healthy people living in one room shacks.

Now onto the issue of underfunded pensions. Today, the PBGC guarantees over $53 billion in unfunded pension promises made by single-employer pension plans. Of this unfunded liability, the PBGC estimates that over $13 billion will very likely be a real liability for the agency. The PBGC's current deficit of $2.9 billion, in its single-employer program, is a dramatic increase over just a few years ago. And the slow down of this growth is nowhere in sight.

As you are all aware, the problem isn't new. Since before 1987, this Committee and the other committees dealing with pension issues have been aware of the fact that big companies, in troubled times, are able to take advantage of the Federal government's defined benefit pension plan insurance system. They promise big pensions to their workers, continually increasing benefits while at the same time making the most minimum funding contributions permitted under the law. These troubled companies eventually terminate their pension plans and shift the cost of their pension debt to the PBGC and renege on promises made to their workers.

Although we addressed this problem in 1987, unfortunately we did not go far enough. Here we are again in 1994, looking at a looming PBGC deficit. Companies and unions continue to use the PBGC not just as an insurer of last resort, but rather as a silent partner with deep pockets, at contract negotiations for wages and benefits.

In the previous Congress, Senator Durenberger and I introduced legislation that would make sure that companies with underfunded pension plans would be held accountable for providing their workers the benefits they promised. Workers need to be assured that employers promises of increased pension benefits is more than a mere illusion. Workers need to know that employers will be held accountable for the promises they make. And employers should only promise what they can afford.

Congressman Jake Pickle, Chairman of the House Subcommittee on Oversight of the Ways and Means Committee also introduced a companion bill in the House. This legislative session, Senator Nancy Kassebaum has joined Senator Durenberger and I in reintroducing our bill, "The Pension Funding Improvement Act of 1993," S. 105. The bill has also been reintroduced in the House by Jake Pickle, as H.R. 298.

I'd like to take a moment to commend Secretary Reich, and other representatives of the Clinton Administration here today for their commitment in addressing the financial status of the PBGC by proposing the Retirement Protection Act of 1993. Although there are differences in our bills, these are predominately in the way to get to our ultimate goal getting underfunded pens ion plans FUNDED. As in health care reform, if we work on a bi-partisan basis we can solve this problem this year. Indeed, this is a much simpler task, as the issues are more limited and consensus more easily obtained.

The Pension Funding Improvement Act of 1993 is a three part bill. Part I of the bill includes stronger funding rules for underfunded pension plans to ensure faster funding of present unfunded obligations. Part II prevents a bad situation from getting worse, by requiring underfunded plan sponsors to immediately fund up their plan or put up collateral in order to increase pension benefits. Part III of the bill includes a Congressional Budget Office and PBGC study of what premium increases would be necessary to balance the PBGC's accounts.

We have heard from unions, affiliated with the auto and steel industries, that companies who offer flat benefit pensions to workers simply cannot afford to put more money into their pension plans. Yet they continue to increase benefits. I am deeply troubled by this. Especially since companies like USX Corporation and Ford Motor company, which have the same type of plan, have been able to do the job. These companies do the right thing and fund their plan. However, they must compete against rivals who put far less into their pension plan in order to sustain the operating budgets of their companies.

If we simply increase premiums to solve the PBGC's deficit problem, we are sending a signal to USX, Ford and others, that not only do they have to pay for their own pension benefits, at some point they will need to pay for the benefits of their competitors. At what point does USX and Ford say they've had enough of this? I'm not sure. PBGC has estimated that under a middle of the road scenario premiums will need to increase to $58 per participant for well funded plans and to, as much as, $219 per participant for underfunded plans. That $219 is still a bargain for a

plan with a good chance of terminating. But is not such a bargain for a well funded plan that will never really need PBGC, even if the plan should end.

Over the past two years, the PBGC, the General Accounting Office, and the Congressional Budget Office have all testified about the 'sorry state of our termination insurance program. They also have stated that the problem will only get worse, and at some point in time require a Congressional bailout, if changes in the law are not made. We can no longer wait to change the law. There is no excuse for allowing a small number of plans to continue to abuse our current system for their own advantage while placing workers, retirees, other responsible plan sponsors, and taxpayers at risk. Therefore, I respectfully ask this Committee to do the right thing. Let's work on a bi-partisan basis and iron out our differences so we can act soon to change the law. The future of the defined benefit plan system depends on it.

In closing, I would like to highlight a part of the Administration's proposal to which I must strongly object. Through their legislation the Administration would eliminate age-weighted profit sharing plans. First, I do not believe that a PBGC bill, intended to reform the funding rules for defined benefit plans, is the proper place to propose an all out ban on age-weighted and cross-tested plans

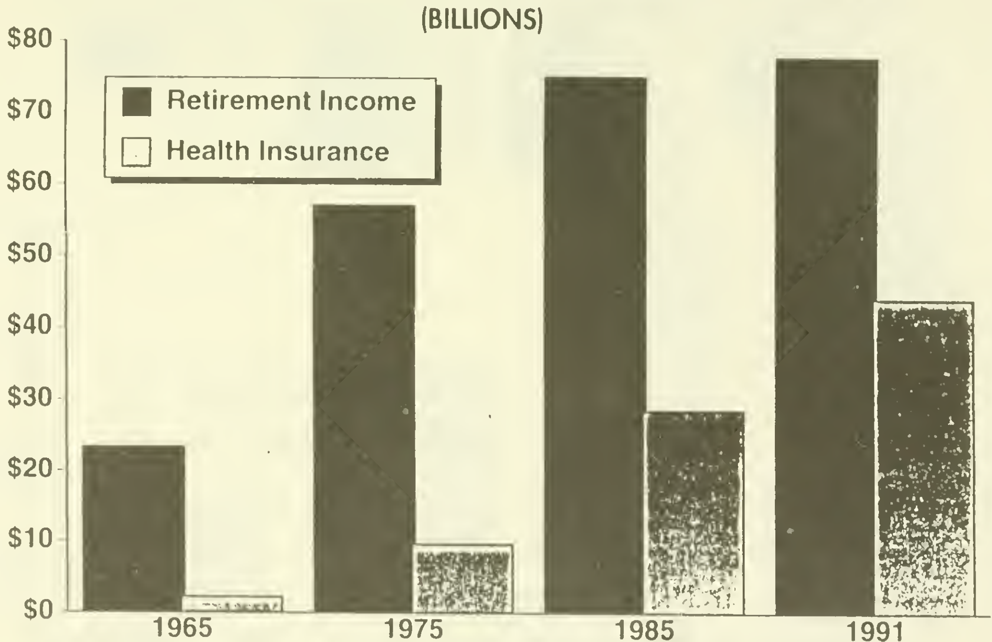
Second, these types of pension plans have gained a lot of attention and many businesses are using them because they are an extremely flexible way to offer pension benefits in the workplace. Plan sponsors have spent millions of dollars over the past several years designing and testing plans in reliance on the consistent position of the IRS and the rules that they have established. I realize that there has been some abuses in this area where rank and file employees are discriminated in favor of highly compensated employees. Well, let's fix the problem by either requiring minimum contributions for lower paid workers or by putting restrictions on plans that blatantly discriminate against younger, rank and file workers. But keep in mind that these pension plans are similar to defined benefit plans, since they reward older employees of all income levels with higher contributions and give lower contributions to younger employees who have more time to finance their retirement. More importantly, let's not kill one of the first vehicles that has come along in a while that actually gives employers incentives to offer pension plans to their workers. I look forward to working with you Mr. Chairman and the Administration in developing a compromise solution to this problem.

Public and Private Employer Spending on Health Care, Retirement, and Wages and Salaries, Selected Years 1965 - 1991

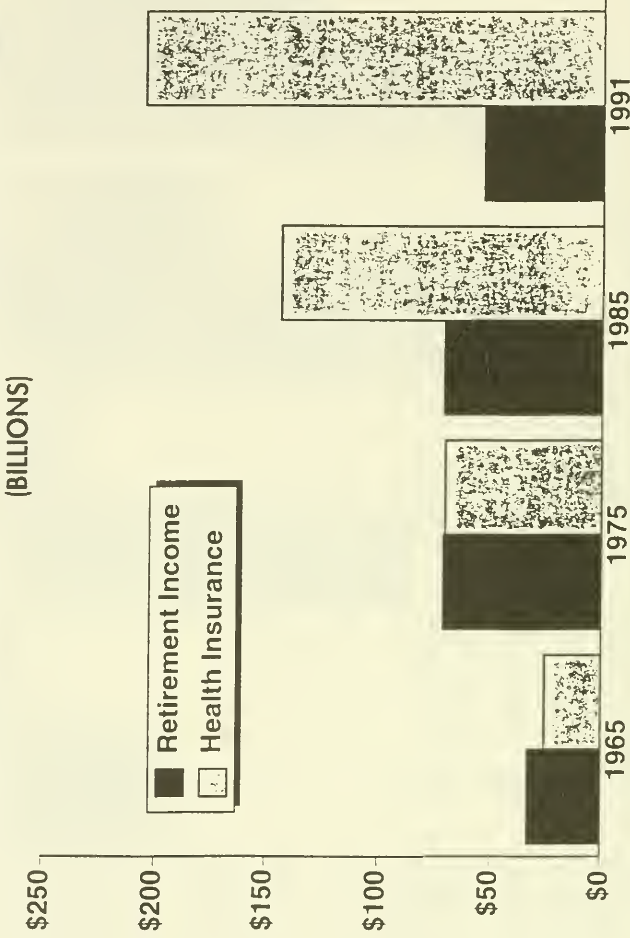
	1965	1970	1975	1980	1985	1990	1991
			($ billions)				
Adjusted for Inflation[a]							
Private Employers							
Private employer spending on wages & salaries	$1,270.3	$1,524.5	$1,616.7	$1,843.5	$2,041.5	$2,323.1	$2,269.8
Private employer spending on health care	25.5	47.7	70.4	106.4	143.5	195.8	205.4
Private employer spending on pension and profit sharing	32.9	48.0	71.1	91.4	70.9	51.6	53.6
Public Employers							
Public employer spending on wages & salaries	302.2	411.1	445.8	432.1	473.0	537.7	545.3
Public employer spending on health care	2.2	3.9	9.6	16.9	28.5	41.3	44.1
Public employer spending on retirement plans	23.3	33.0	57.0	67.3	75.1	77.2	77.9
Current Dollars							
Private Employers							
Private employer spending on wages & salaries	293.8	434.3	638.6	1,115.3	1,612.8	2,229.3	2,269.8
Private employer spending on health care	5.9	13.6	27.8	64.4	113.4	187.9	205.4
Private employer spending on pension and profit sharing	7.6	13.1	28.1	55.3	56.0	49.5	53.6
Public Employers							
Public employer spending on wages & salaries	69.9	117.1	176.1	261.4	373.7	516.0	545.3
Public employer spending on health care	0.5	1.1	3.8	10.2	22.5	39.6	44.1
Public employer spending on retirement plans	5.4	9.4	22.5	40.7	59.3	74.1	77.9

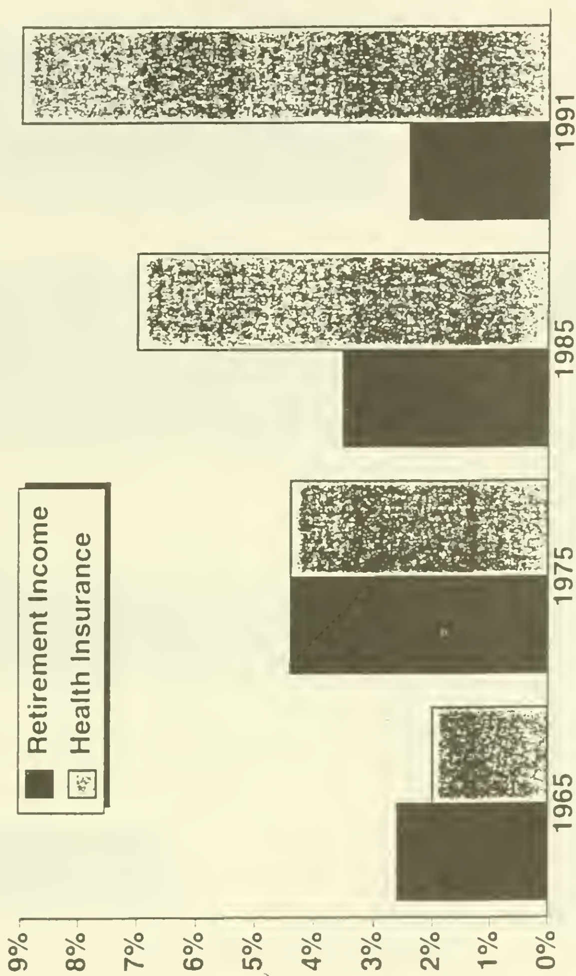
Source: Employee Benefit Research Institute tabulations of data from Cathy A. Cowan, MBA and Patricia McDonnell "Business, Households and Governments: Health Spending 1991" *Health Care Financing Review Spring 1993* and U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business, August 1993* and *The National Income and Product Accounts of the United States: Statistical Supplement, 1959-1988,* vol. 2.

[a]Adjusted to 1991 dollars.

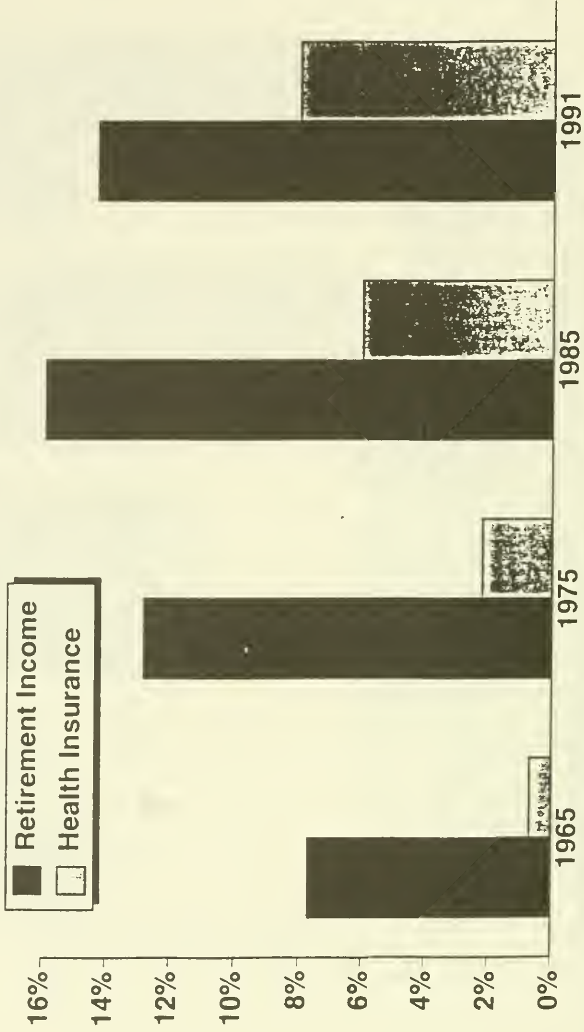


Public Employer Spending on
Health Insurance and Retirement Income
(BILLIONS)
Retirement Income
Health Insurance
$80
$70
$60
$50
$40
$30
$20
$10
$0
1965
1975
1985
1991
Source: Employee Benefit Research Institute
Health Insurance


Private Employer Spending on
Health Insurance and Retirement Income
(BILLIONS)
Retirement Income
Health Insurance
$250
$200
$150
$100
$50
$0
1965
1975
1985
1991
Source: Employee Benefit Research Institute



88-738 O - 95 - 3


Public Employer Spending on
Health Insurance and Retirement Income
as a Percentage of Wages and Salaries
Retirement Income
Health Insurance
16%
14%
12%
10%
8%
6%
4%
2%
0%
1965
1975
1985
1991
Source: Employee Benefit Research Institute
Health Insurance

STATEMENT OF THE ERISA INDUSTRY COMMITTEE
BEFORE THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
HEARING ON S.1780
THE RETIREMENT PROTECTION ACT OF 1993
JUNE 15, 1994

PRESENTED BY
CHESTER S. LABEDZ, JR.

TEXTRON INC.

Chairman Moynihan and members of the Committee, good morning. My name is Chester S. Labedz, Jr. I am pleased to appear before you today on behalf of The ERISA Industry Committee, generally known as "ERIC."

I am the Chairman of ERIC's Title IV Task Force. In that capacity I have participated actively in the formulation and presentation of ERIC's positions on pension funding and termination insurance issues for many years. I also serve as Vice President - Human Resources at Textron Defense Systems.

THE ERISA INDUSTRY COMMITTEE

ERIC represents the employee benefits interests of the nation's largest employers. Nearly all of ERIC's members employ more than 10,000 employees, and a number of them have hundreds of thousands of employees. ERIC's members share with the members of the Committee a strong interest in the success, expansion, and security of the private-sector employee benefit plan system. Virtually all of ERIC's members sponsor one or more defined benefit pension plans. These plans have been remarkably successful in addressing the retirement security needs of millions of employees and their beneficiaries.

ERIC has vigorously supported in the past, and continues to support, strong pension funding standards and a sound termination insurance program. Over the years, ERIC has devoted thousands of hours and committed a substantial portion of its resources to supporting legislation that will improve pension funding and strengthen the single-employer termination insurance system.

On June 8, 1993, ERIC presented to the Congress and the Administration a plan to strengthen pension funding rules and the government program that guarantees benefits under defined benefit pension plans. *(See*

Attachment "A".) The proposal reflects the consensus of a broad range of major employers, including both those sponsoring fully funded plans and those sponsoring less than fully funded plans, on changes needed to provide an effective and coherent structure for funding defined benefit pension plan promises.

I respectfully ask that my written statement, and the ERIC proposal *(Attachment "A")*, together with two additional proposals *(Attachments "B" and "C")* that ERIC developed in response to S.1780, be included in the full hearing record.

ERIC SUPPORTS A STRONG DEFINED BENEFIT PLAN SYSTEM

A vibrant defined benefit plan system and a sound termination insurance program require a regulatory environment that --

- encourages the formation and continuation of voluntary pension plans,
- encourages employers to make only the pension promises they can keep and to keep the promises they make, and
- protects employees where protection is necessary and consistent with the foregoing principles.

These objectives are fully consistent with the purposes of the termination insurance program and the mission of the Pension Benefit Guaranty Corporation ("PBGC") stated in ERISA:

- to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants,
- to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries, and
- to maintain termination insurance premiums at the lowest level consistent with carrying out the PBGC's obligations.

The private pension system is a voluntary system. To the extent that employers cease forming new plans or terminate existing plans, retirement security is diminished: fewer workers earn pension benefits, the termination insurance premium base is eroded, and the retirement security of all workers is weakened. Sound funding standards are essential to the success of the private pension system; however, any revisions to the funding standards or to the termination insurance

program that make excessive demands on employers will discourage the formation and expansion of pension plans.

The premium rates under the termination insurance program raise a similar issue. Although the PBGC requires premium payments in order to meet its obligations, we are gravely concerned that escalating PBGC premiums will encourage employers to abandon defined benefit plans.

As an alternative to raising premiums, ERIC has proposed a package of amendments to the Internal Revenue Code (IRC) that will (1) increase tax revenue, (2) reduce administrative costs, and (3) increase corporate executives' interest in maintaining well-funded pension plans. The ERIC proposal would extend and expand the ability, under IRC §420, of pension plans to use excess assets to pay retiree medical benefits; repeal the administratively complex, but seldom applicable, limit in IRC §415(e) on benefits provided by a combination of defined benefit and defined contribution plans; and amend IRC §401(a)(16) to allow plans that are in full funding to pay excess plan benefits. These proposals are described in detail in *Attachment "B"*. We are pleased that Senator Danforth has requested a revenue estimate on the §420 transfer provision and appreciate his interest and the interest of others on the Committee in this proposal.

In addition, ERIC developed modifications to the Administration's proposal in S.1780 to eliminate the ability of defined contribution plans to satisfy the Treasury Department's nondiscrimination requirements by testing the plans on a benefits basis -- a procedure commonly called "cross-testing." The Administration proposal is irrelevant to the central concern of the bill. It appears to be motivated, not by concern for the security of defined benefit plans, but by revenue considerations and concerns regarding the application of the Treasury's recently issued nondiscrimination regulations to defined contribution plans. In any event, the proposal is far broader than necessary to achieve these aims. There are many large, long-standing, and nondiscriminatory plans that rely on cross-testing, and Administration representatives have stated publicly that the Administration does not intend to prohibit these plans from continuing to use cross-testing. Accordingly, the Administration's proposal must be substantially narrowed. *Attachment "C"* to this statement presents ERIC's recommendation on how to refine the Administration's over-broad cross-testing proposal.

S. 1780

IN GENERAL. Although S.1780 is intended to address pension funding and security issues constructively, the bill does not address the fundamental

problems facing defined benefit plans. S.1780 appears to be designed primarily to protect the PBGC, rather than the plans that the PBGC insures. For example, the bill proposes a substantial increase in PBGC premiums by lifting the dollar limit on the variable rate premium. In our view, however, the central focus of any legislation should not be to "fix" the PBGC, but should be to place the private pension system on a solid foundation. A premium increase will not do this. In fact, if the pension funding standards are appropriately reformed, the premium rate can be and should be reduced. This must be done if we are to maintain a vibrant defined benefit plan system.

S. 1780 does require more rapid funding of defined benefit plans. However, the bill's requirements not only leave the PBGC exposed, but are so harsh and volatile that they will cause serious harm to the defined benefit system, especially after the end of the temporary relief provided during the bill's transition period.

By contrast, in developing its proposal, ERIC focused on establishing funding standards that require faster funding of new obligations under the basic funding rules that apply before a plan experiences in financial difficulty and that are designed to avoid large fluctuations from year to year in the amounts employers are required to contribute to their plans.

Although we have objections to numerous provisions of S.1780, we would like to focus today on four features of the bill that give us particularly strong concerns:

- the bill's mandated interest and mortality assumptions,
- the bill's highly volatile and unpredictable contribution requirements,
- the bill's failure to provide appropriate transition from the current funding requirements to the bill's new funding requirements, and
- the bill's proposal to authorize the PBGC to interfere with and disrupt many normal, nonabusive business transactions.

MANDATED ASSUMPTIONS. S.1780 would narrowly restrict the interest rates that may be used to determine a plan's current liability for funding purposes. In addition, the bill would require all plans to use the same mortality table to determine their current liability. Although these proposals might appear to be technical and innocuous, they are extremely substantive, and they will have a severe effect on the pension funding requirements. ERIC believes that the proposals are inappropriate and strongly objects to both of them.

<u>(1) Interest Assumptions.</u> Under the bill, the interest assumption used to calculate a plan's current liability could not be more than 100 percent or less than 90 percent of the trailing four-year weighted average of the rates of interest on 30-year Treasury bonds. Currently, an interest rate of up to 110 percent of this average can be used.

Because pension funds are typically invested in a diversified array of corporate debt and equity securities, and not exclusively in Treasury bonds, their normal rate of return is substantially higher than the average return on Treasury bonds. For example, while the four-year average Treasury rate was approximately 8.8% during the last four years, most pension funds expected to earn above 8.8% and actual returns were even higher than expected. Many plans had average earnings between 12% and 16% during this period.

The Treasury bond rate substantially understates the rate of return that pension funds can be expected to earn and therefore overstates the present value of their future liability. Current law attempts to recognize this fact by allowing a plan to use a rate of up to 110% of the Treasury bond rate.

ERISA already requires the plan's actuary to use reasonable actuarial assumptions for funding purposes, and we do not think there is any need to mandate assumptions that are more conservative than necessary. Even the Financial Accounting Standards Board ("FASB"), which establishes the financial accounting standards for corporate financial statements, requires the use of a corporate bond rate, rather than the Treasury bond rate. At the end of 1993, high-quality corporate bonds were yielding from 7.0% to 7.5%, which is far more than 100% of the then-prevailing Treasury bond rate of 6.25% that would have been required under the Administration's bill.

Calculations made by ERIC members show that the bill's mandated interest assumption can produce liabilities that are from 5% to 10% greater than those produced by the conservative FASB interest assumption and nearly 30% higher than the liabilities measured using the rate of return expected to be earned by the funds. I have attached to my statement a chart that illustrates how the bill's mandated interest assumption will dramatically overstate the amount that an employer needs to fund. *(<u>See</u> Chart immediately following written statement.)*

<u>(2) Mortality Assumptions.</u> Under the bill, the mortality table used to determine a plan's current liability would be the most recent standard table prescribed by the National Association of Insurance Commissioners to determine the reserves for group annuity contracts. Currently, the standard table is the GAM 1983 mortality table; the table is expected to change within the next year to the GAM 1994 mortality table.

The proposal to mandate the use of a uniform mortality assumption is unjustified. The mortality experience of individual plans often varies significantly, and there is no sound reason for prohibiting the liability of an individual plan from being calculated on the basis of the plan's projected experience, rather than on the basis of a uniform table that is not based on the plan's experience.

The bill also mandates the use of the GAM 1983 table for disabled participants as well as for healthy participants. Applying the GAM 1983 table to disabled participants may be inappropriate and can greatly overstate the plan's liability to these participants.

As I mentioned earlier, ERISA currently requires the plan's actuary to adopt reasonable actuarial assumptions for funding purposes. There is no justification for overriding the actuary's judgment by requiring the use of assumptions that are demonstrably inappropriate in many cases.

This is not just a technical point. Calculations by ERIC members indicate that if the GAM 1983 table is mandated, the estimated present value of their pension liabilities will increase by as much as 8 - 19%.

The use of demonstrably inappropriate mortality assumptions to overstate a plan's liabilities is unjustified. It will impose excessive and unnecessary financial burdens on employers, and it ultimately will lead to overfunding of pension plans.

Taken together, the bill's mandated assumptions raise liabilities in some plans as much as 20% over those produced by the conservative estimates used in company financial statements. In addition, the artificially high liabilities created by the bill's mandated assumptions will subject many plans that are adequately funded for current needs to pay a variable rate premium for the first time. Moreover, under the bill, the variable rate premium amount would be uncapped. This is an unreasonable diversion of funds that otherwise could be productively used for additional plan contributions or for business investment purposes and further erodes the long-term stability and health of the defined benefit system.

VOLATILE AND UNPREDICTABLE CONTRIBUTION REQUIREMENTS. S.1780 revises the current pension funding standards primarily by strengthening the "deficit reduction contribution" requirements of current law and expanding their application. (The deficit reduction contribution of current law is a funding requirement that is applied in addition to normal funding requirements.)

ERIC believes it is a mistake to focus on the deficit reduction contribution. The deficit reduction contribution applies only to plans whose funding

condition is less than optimal and thus applies only after the plan has experienced funding difficulties. A deficit reduction contribution is thus an after-the-fact remedy.

The deficit reduction contribution requirement also significantly increases the volatility and unpredictability of the funding requirements. A plan can be subject to the deficit reduction contribution requirement in some years but not in others, depending on interest rate fluctuations, collective bargaining cycles, investment results, and other variables -- most of which are outside of the control of the plan sponsor. As a result, a plan can be subject to markedly different contribution requirements from one year to the next, depending on whether the deficit reduction contribution requirement applies in that year. Highly volatile and unpredictable contribution requirements discourage employers from adopting or expanding defined benefit plans and make it difficult for companies to make reliable long-term plans. This is not in the interest of our economy or the defined benefit plan system.

The Administration has stated that it has focused its recommendations on the deficit reduction contribution in order to affect only plans that are underfunded. However, the Administration's bill affects many plans that have assets adequate to meet current liabilities. In addition, under the bill's volatile funding rules, plans may bounce in and out of the bill's harsh funding requirements from one year to the next, causing substantial and unnecessary disruption in a business's operations.

In addition, the deficit reduction contribution often saddles an employer with its heaviest funding obligations at the time it can least afford to bear them: at the down point of the business cycle, when security prices and asset values also can be depressed, and when the employer's cash position typically is weak. Deficit reduction contributions thus can impair the ability of an employer to recover from its current financial difficulties.

We recommend that the Committee focus instead on fashioning strong and appropriate basic funding standards that require faster funding of new obligations under the basic funding rules which apply before the plan is subject to a deficit reduction contribution requirement. This will lead to sounder long-run funding and reduce the highly volatile contribution requirements that are the inevitable result under S.1780.

ERIC asks the Committee to address these concerns in its deliberations. ERIC will be pleased to work with the Committee in this regard.

POST-TRANSITION WALL. S.1780 includes a transition rule that limits the mandatory increase in the level of an employer's contributions for seven years.

We appreciate the stated objective of the proposed transition rule: to prevent the bill's funding requirements from becoming excessive. However, the proposal merely defers the full impact of the bill's funding requirements.

The result of the Administration's proposal is that an employer can hit a "wall" of new contribution requirements as soon as the transition period expires. For example, one company estimates that although the proposed transition rule will moderate the increases in its funding obligations for seven years, the company's annual funding obligations will skyrocket after the transition period expires and will virtually double in 2002 and 2003 (the first two years after the transition period expires). Other companies may not have to make additional contributions, other than those required by current law, during the Administration bill's transition period, but will face additional requirements as soon as the transition period expires. By contrast, under the ERIC proposal, some companies would make higher contributions in the early years than what is required under S.1780, but would not hit a contribution "wall" in the out years.

We strongly support designing and phasing-in new funding requirements so that an employer will not hit a "wall" like that established by the Administration's proposal.

PBGC INTERFERENCE WITH NORMAL BUSINESS TRANSACTIONS. S.1780 requires employers with more than $50 million in unfunded vested benefits to give advance notice to the PBGC of certain business sales and other dispositions and allows the PBGC to hold up the transaction and to bring an enforcement action in court if the parties do not meet any demands that the PBGC makes to protect its interests (such as by seeking additional funding or collateral).

We strongly oppose this provision. The provision will allow the PBGC to interfere with and disrupt many normal, nonabusive business transactions that are not based on pension considerations. The PBGC will have undue leverage in these circumstances. If the parties wish to consummate a proposed transaction, they will have no practical alternative to meeting the PBGC's demands. Moreover, in many cases, if a transaction cannot be consummated promptly, it will not be consummated at all. As a result, a PBGC demand often will terminate a proposed transaction.

It is important to understand that these provisions will affect all businesses, not just businesses with underfunded pension plans. The prospect of

PBGC intervention may deter businesses with well-funded plans from entering into business arrangements that make economic sense (for example, an acquisition of a company with an underfunded plan by a company with a fully funded plan). Businesses with underfunded plans will have their economic health materially harmed because they will find that the potential for PBGC intervention will cause fewer companies to be willing to engage in transactions with them. The results will gravely harm both the economy as a whole and the security and strength of the defined benefit system in particular.

The PBGC should not be given this inordinate authority. Although there is a substantial risk that the proposed provision will interfere with, and even prevent, commonplace and unobjectionable business transactions, the Administration has not shown that the provision is essential to improving the PBGC's financial condition. The key to the security of the private pension system and the PBGC is improved funding, not the introduction of unnecessary and disruptive enforcement techniques.

CONCLUSION

As I mentioned earlier, ERIC has a long history of supporting strong pension funding standards and a sound termination insurance program. Indeed, ERIC's proposal appears to require faster funding for some companies for the remainder of this decade than does the Administration's proposal. Although we object to many of the Administration's proposals, we support improvements in the current pension funding standards and the termination insurance program. We are willing to work with the Committee and its staff to explore whether there is room for compromise that will accommodate our concerns.

We urge the Committee to revise S.1780 to address issues I have voiced today regarding interest and mortality assumptions, the volatility of the contribution requirements, the proposed transition rule, and PBGC enforcement. Although we also have other significant concerns with the bill, we believe that progress is most likely to be made if agreement can be reached on these important issues first.

We thank you, Mr. Chairman, for the opportunity to testify. We look forward to working with the Committee and its staff on improvements in the funding standards and the termination insurance program for defined benefit pension plans.

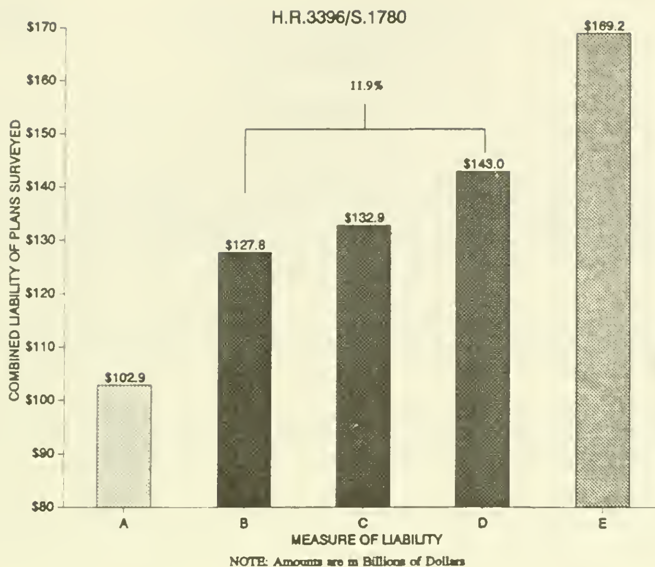
G/T/FINANCE.TTV
6/13/94

How Much Funding is Enough?

H.R.3396 & S.1780 Impose Pension Funding Targets That Far Exceed Actual Plan Needs

Several large employers have measured the value of their plan liabilities, using various interest and mortality assumptions. The chart on the following page compiles the data from these plans, some of which are underfunded and some of which are fully funded under current law. The chart shows the dramatic increase in the estimated value of liabilities that is caused by the Administration's pension funding and Pension Benefit Guaranty Corporation (PBGC) reform legislation (H.R.3396/S.1780), which mandates that all plans use the same specified interest and mortality assumptions, regardless of whether the assumptions are appropriate for each plan.

To have a plan whose assets meet the pension funding targets in H.R.3396/S.1780, an employer must take scarce cash that otherwise would fund ongoing business operations, research, and development, and deposit the cash in its pension plan, even though there is little reason to believe the cash will be needed to fund the plan's current benefit liabilities. The chart on the following page illustrates this point.



COLUMN A: *Combined plan liabilities using current long-term earnings assumptions and plan-specific mortality assumptions.* These assumptions are appropriate because pension funds have diversified portfolios that yield higher average returns than Treasury or corporate bonds and because many plans have mortality experience that differs significantly from the insurance company experience on which standard mortality tables are based.

COLUMN B: *FY 1993 FASB discount rate and plan-specific mortality assumptions.* The FASB discount rate is based on returns on corporate bonds. Measuring liabilities on this basis meets the conservative funding standard required by the SEC for disclosure in a company's financial statements.

COLUMN C: *Mandated interest proposed in H.R.3396/S.1780 and plan-specific mortality assumptions.*

COLUMN D: *Mandated interest and mortality assumptions proposed in H.R.3396/S.1780.*

Columns C and D show the impact of the mandated interest and mortality assumptions proposed in the Administration's bill. For the plans surveyed, this produces an increase in estimated liability of 11.9% beyond that deemed sufficient by the SEC (which requires a measure of investment return that is significantly below actual plan investment experience).

COLUMN E: *Required interest rate for calculating PBGC premiums and mandated mortality assumptions.* Under H.R.3396/S.1780, any plan that falls $1.00 below full funding (as measured under Column D) must pay a variable rate premium to the PBGC. The amount of the premium is based on liabilities that are measured by using an interest assumption that is even lower than that used under Columns C and D, together with the bills' mandated mortality assumptions.

THE ERISA INDUSTRY COMMITTEE **ATTACHMENT A**

Pension Funding and ERISA Title IV:
A Proposal For Reform

Introduction

The ERISA Industry Committee (ERIC)[1] has for many years recognized that something must be done to strengthen defined benefit pension plan funding and the Pension Benefit Guaranty Corporation's (PBGC) termination insurance program. We have been in the forefront of efforts to strengthen plan funding and the termination insurance system. Over the past year, a task force that included a cross-section of ERIC members from a variety of industries has worked intensely to develop recommendations for remedial legislation.

As a result our task force's efforts, ERIC has adopted a proposal that is designed to protect defined benefit plans and their participants through a combination of accelerated funding for plans with unfunded current liabilities, coordinating the funding rules with the tax deduction rules and PBGC guarantees, and clarifying and reforming the PBGC's status in bankruptcy.

ERIC does not believe that "fixing the PBGC" should be the central focus of reform. If more money is to be committed to the defined benefit plan system, it should be invested where it will do the most good: in the pension plans themselves in the form of increased funding.

A premium increase is not the solution to the problems of the defined benefit plan system. With adequate funding, the premium rate can be and must be reduced if we are to maintain a vibrant defined benefit plan system.

A vibrant defined benefit system includes a sound termination insurance program and a regulatory environment that:

- encourages the formation and continuation of voluntary pension plans;
- encourages employers to make only the pension promises they can keep, and to keep the promises they make; and
- does not give employers or unions a blank check on which they can make pension promises that they cannot keep but that will be guaranteed by the Government and other employers.

The formation and continuation of voluntary pension plans is essential to the health and success of the defined benefit plan system. With the work force growing older and more sensitive to retirement, workers will be seeking greater retirement security. In many cases, that will mean increased pressure for defined benefit pensions.

ERIC believes that sound funding and sound funding standards are the key to greater security for defined benefit pension plans and the employees who participate in them. Revisions to the funding standards or to the termination insurance program must not make unreasonable demands that will discourage plan formation and continuation.

If employers cease to form new plans and begin to terminate existing plans, retirement security will be diminished for all workers. Thus, any change in the funding standards must strike a balance between the need

---

[1] *The ERISA Industry Committee (ERIC) is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers and is the only organization representing exclusively the employee benefits interests of major employers. ERIC's members provide comprehensive retirement, health care coverage and other economic security benefits directly to some 25 million active and retired workers and their families. The association has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.*

for sound funding, on the one hand, and the need to preserve and expand the private pension system, on the other.

ERIC supports applying stronger funding standards to less than fully funded plans on a prospective basis. If an employer knows in advance that it will be subject to more stringent funding standards, it can then decide in advance whether it can afford to increase benefits and funding in a less than fully funded plan.

When employers agreed in past years to amend their plans to increase benefits, they did so on the basis of the estimated costs of the benefits in reliance upon the law's existing funding standards. Thus, it would be inequitable for Congress now to make dramatic retroactive changes in employers' funding obligations, long after the employers became obligated to provide the additional benefits and before the employers had any knowledge of the additional costs that any new funding standards would impose.

Employers should not make, nor should unions demand, pension promises that cannot be kept. As the termination insurance program's premium payers and as those who bear the cost of the unfunded guaranteed benefits promised by terminated plans, we support measures to assure that employers keep their pension promises and to limit the pension benefits that the PBGC guarantees.

In the collective bargaining context, current law also gives precisely the wrong incentive to a union: it encourages a union to bargain for additional pension benefits from a financially-pressed employer. The union knows that if the employer is unable to fund the additional benefits, the termination insurance program will provide them.

The termination insurance system cannot survive if the law provides a blank check that can be used to make pension promises that are guaranteed by the PBGC and financed by other employers.

We therefore support an approach that would more closely link the extent of the PBGC's guarantee to the plan's funded status. The law already recognizes that it is inappropriate to extend PBGC guarantees to business owners before the plan's benefits are scheduled to have been adequately funded. ERIC urges that the concept of linking guarantees to scheduled funding be extended to all employees.

ERIC strongly opposes a premium increase as a remedy for the ills of the termination insurance program. In recent years, the premium rate has skyrocketed from $2.60 per participant (as recently as 1985) to the current rate of $19 per participant plus a variable premium of as much as $53 per participant -- an aggregate premium of as much as $72 per participant.

These substantial premium increases are already driving employers out of the defined benefit system, thereby narrowing the PBGC's premium base and weakening the program that the premiums are intended to support.

In ERIC's view, any legislation in this area should be designed to avoid the need for future premium increases and to set the stage for premium reductions in the future.

The ERISA Industry Committee

Pension Funding and ERISA Title IV:
A Proposal For Reform
June 8, 1993

I. In General

A. ERIC supports protecting defined benefit plans and their participants through a combination of accelerated funding for plans with unfunded current liabilities, coordinating the funding rules with the tax deduction rules and PBGC guarantees, and clarifying and reforming the PBGC's status in bankruptcy.

B. The current funding rules do not work for all types of plans, in particular, flat dollar plans and plans with lump-sum payouts.

C. However, certain legislative proposals that have been made are unfair and are potentially counterproductive.

II. Minimum Funding Requirements

A. Any proposal to mandate accelerated funding should relate primarily to future plan amendments.

1. Companies cannot reduce the benefit promises they made in the past. They granted benefit improvements on the basis of their ability to fund the improvements in accordance with current law (i.e., over 30 years or at the percentages specified in OBRA '87).

2. At this time, a change in the minimum funding requirements for benefit promises made in the past would be unfair: it would change the rules in the middle of the game.

B. The minimum funding schedule for plan amendments adopted after December 31, 1992, should be accelerated to the extent these amendments cause the plan to have unfunded current liability on a termination basis or increase the unfunded current liability of a plan that already has unfunded current liability.

1. New unfunded current liabilities caused by past service amendments related to active employees should be amortized over 10 years.

2. New unfunded current liabilities caused by past service amendments related to already-retired or terminated employees should be amortized over 5 years.

3. A shutdown, "window," or similar benefit should be treated as a plan amendment for already-retired employees, effective when the event occurs, and should be amortized over the lesser of (a) 5 years or (b) the weighted-average payout period for the benefit.

4. The funding requirements for plans that are less than 100% funded[1] should take into account all promised benefit increases, including increases scheduled to become effective in future years (*i.e.*, not just the first-year benefit increase under a three-year agreement). This treatment should be optional for plans that are at least 100% funded after reflecting the amendments.

5. Special rules for plans with unfunded current liabilities that have lump-sum payment provisions.

a. The amortization period for any plan amendment should not be less rapid than the rate at which the liability created by the amendment is paid out. If new or increased

lump-sum amounts are paid in any year, funding at least equal to those amounts should be required for that year.

b. To the extent lump-sum payments in a plan with unfunded current liability decrease the plan's funded ratio, contributions to offset that decline should be made for that plan year.

c. The foregoing rules should apply to plans that purchase annuity contracts as well as to plans that provide for lump sums.

6. Special rules would apply to plans with substantial unfunded current liabilities.

C. Detailed Funding Rules

1. This proposal modifies the speed of funding new plan amendments and other items under §412(b). Section 412(l) remains in effect.

2. If a plan has assets (not reduced by any credit balance) less than its current liability (measured as under current law) after a plan amendment increasing benefits, two (or three) new amortization charge bases will be established under I.R.C. §412(b) to effect faster funding for the additional accrued liability under the plan's funding method:

a. First, to the extent the accrued liability for active participants increases, a 10-year base is established.

b. Second, to the extent the accrued liability for retired and terminated participants increases, a 5-year base is established.

c. These bases will be replaced with a 30-year base to the extent of the amount by which the assets exceeded the plan's current liability immediately before the amendment.

3. If a plan has assets (not reduced by any credit balance) less than 75% of the plan's current liability (measured as under current law) as of the beginning of the year, the following rules will apply:

a. If the valuation interest rate exceeds the Current Liability Base Rate (i.e., 100% of the current liability base rate under I.R.C. §412(b)(5)), the interest rate used to compute all minimum funding standard account charges and credits under I.R.C. §412(b) (but not under I.R.C. §412(l)) must be changed to a rate not higher than the Current Liability Base Rate.

b. The plan will be subject to a minimum funding requirement equal to the greater of the amount otherwise required by this proposal or the following:

i. Interest (determined on the basis of the current liability interest rate) on the plan's unfunded current liability; plus

ii. The normal cost (on a current liability basis) under the unit credit method accrued during the year; plus

iii. The current year's amortization of outstanding funding waivers.

---

[1] "Less than 100% funded" is based on a comparison of assets to current liability and does not include funding for projected benefits.

Any credit balance in the plan's funding standard account will be available to meet this requirement.

4. The required change to the Current Liability Base Rate will be treated in the minimum funding standard account as any other change in the valuation interest rate.

   a. Each existing amortization base will continue to be amortized over its remaining amortization period, although the annual charge or credit will change due to the interest rate change.

   b. A new amortization base will be created equal to the increase in accrued liability due to the interest rate change. This base will be amortized over 10 years.

5. If a phased-in increase in benefits is negotiated under a plan that is less than 100% funded, the funding standards should immediately reflect the full extent of the benefit increase promised, regardless of whether the full amount of the increase is effective immediately. This treatment should be optional for a plan that is at least 100% funded.

6. All plans (regardless of funded status) should amortize actuarial gains and losses over a 10-year period for both minimum funding and tax deduction purposes, except that a plan that is less than 100% funded should be required to amortize losses over a 5-year period for both minimum funding and tax deduction purposes.

   a. The current liability under a newly established plan should be amortized over 10 years.

7. If there is a change in the actuarial assumptions for a plan that is less than 100% funded, both the change and the reasons for the change should be disclosed in the plan's Form 5500.

8. The foregoing provisions will be effective for plan amendments adopted after December 31, 1992.

D. Appended to this proposal are a table that summarizes the proposal and examples that illustrate how the proposal will work.

III. Tax Deduction Limits

A. Conform the limits on the deductibility of plan contributions to the minimum funding requirements. Current law requires spreading the costs of certain events over a period of at least 10 years for tax deduction purposes. This period should be changed to the lesser of 10 years or the period under the minimum funding rules.

B. Amend the 25% deduction limit in I.R.C. §404(a)(7) to permit an employer that maintains both a defined benefit plan and a defined contribution plan to deduct

1. Contributions to fund the defined benefit plan's unfunded current liability, as if the employer did not maintain a defined contribution plan, and

2. The employer's contribution to its defined contribution plan.

IV. PBGC Guarantees

A. For new plan amendments, the PBGC guarantee should be phased in and tied to the minimum funding schedule for plans that are less than 100% funded. Thus, guarantees should phase in over 5 or 10 years, depending on the minimum funding period.

B. For new plan amendments, the minimum annual increase in the guarantee of $20 per month should be rescinded.

C. The rights of participants and beneficiaries in the event of plan termination should be changed to conform to the proposed change in the guarantee phase-in rules; as yet unfunded (and thus unguaranteed) liabilities related to amendments after December 31, 1992, should be placed last in the asset allocation schedule that appears in ERISA §4044.

D. If funding falls below the minimum required (*e.g.*, in bankruptcy or during the period for which a funding waiver is in effect), the increase in the PBGC guarantee will be halted. No funding means no guarantee.

E. The practical consequence of ERIC's proposal is that after a transition period (i.e., after today's guaranteed amounts are funded), the PBGC's risk will be limited to actuarial losses.

V. Bankruptcy

A. ERIC supports conforming the Bankruptcy Code with the provisions of ERISA. ERIC supports amending the Bankruptcy Code to (a) recognize pension contributions as administrative expenses that are paid during bankruptcy and (b) strengthen the PBGC's claim to contributions missed before the plan sponsor filed for bankruptcy.

B. The proposed changes in the guarantee provisions, described above, should prevent companies from increasing the PBGC's exposure while they are in bankruptcy.

C. The PBGC also should have the option to join unsecured creditors' committees.

D. ERIC does not support increasing the PBGC's claim above the historic 30% of net worth limit; this could damage the interests of existing creditors and could cause creditors to try to negotiate to improve their credit positions. This could seriously damage a company's access to the credit markets.

VI. PBGC Premiums

A. ERIC's proposal should allow near-term (if not immediate) reduction in PBGC premiums.

VII. Budget Rules

A. ERIC supports removing changes in the funding requirements and tax deduction rules from the budget's pay-as-you-go requirements. Improvements in pension funding will reduce the PBGC's liabilities in the long run, and should not have to be balanced by increases in current Government revenues.

VIII. No Future Changes

A. If ERIC's proposal is adopted, it is anticipated that no additional changes to the law to protect plan participants or to manage the PBGC liability will have to be considered for many years and that premium reductions can be enacted.

7

SUMMARY

Percent Funded	Treatment of Plan Amendment Liabilities	FSA Interest Rate Requirement
100% +	Current law • 30-year amortization • May incorporate bargained benefit increases	Current law • Actuary's "Best Estimate"
75-100%	• 5 years for retirees • 10 years for actives • Must incorporate bargained benefit increases	Current law • Actuary's "Best Estimate"
Under 75%	• 5 years for retirees • 10 years for actives • Must incorporate bargained benefit increases • Other special funding requirements apply	Change to Current Liability Base Rate

EXAMPLES

Example 1

	Prior to Amendment	After Amendment
Current Liability	$ 90,000	$115,000
Actuarial Value of Assets	100,000	100,000
Funded Ratio	111%	87%
Accrued Liability at Valuation Rate (Exceeding Mandated Rate)		
Actives	95,000	110,000
Retirees	25,000	40,000
New § 412(b) Amortization Bases		
(a) Tentative 10-year base for actives		$15,000 (110,000-95,000)
(b) Tentative 5-year base for retirees		15,000 (40,000-25,000)
(c) Assets exceed prior current liability		
(d) Adjusted 5-year base for retirees		10,000 (100,000-90,000)
		5,000 (15,000-10,000)

Base 1: $15,000 over 10 years
Base 2: $ 5,000 over 5 years
Base 3: $10,000 over 30 years

Example 2 - Next Year

	Beginning of Year
Valuation Interest Rate	9.00%
Current Liability Base Rate	8.07%
Current Liability	$140,000
Actuarial Value of Assets	$101,000
Funded Ratio	72%

- Because the plan is less than 75% funded at the beginning of the year, the interest rate for I.R.C. §412(b) funding calculations must be dropped from the 9.0% rate to a rate no higher than 8.07% (i.e., 100% x 8.07%).
- Calculation of the current liability and the funding charges under I.R.C. §412(l) are still based on an interest rate within the 90% - 110% corridor around the 8.07% Current Liability Base Rate.
- This change will result in significantly higher charges for the year and a larger funding requirement.

G:\T\FINTITTV.123

THE ERISA INDUSTRY COMMITTEE **ATTACHMENT B**

PROPOSAL TO SIMPLIFY ADMINISTRATION AND ENCOURAGE FUNDING OF PENSION PLANS

SUMMARY

Under recent changes in the law, corporate executives have less and less incentive to assure the maintenance and funding of pension plans. Not only are there multiple, costly administrative burdens associated with maintaining pension plans, also but the executive's own benefit security is increasingly divorced from the welfare of the pension plan. Federal tax revenue needs have also contributed to poor funding incentives.

This proposal would:

- ♦ Increase tax revenues;
- ♦ Decrease administrative costs; and
- ♦ Increase executives' interest in maintaining well funded pension plans by granting plans that are in full funding:
  - increased flexibility,
  - further decreases in administrative costs, and
  - additional security for certain nondiscriminatory benefits.

PROPOSAL COMPONENTS:

The proposal would involve changes to three Internal Revenue Code (IRC) sections:

1. Repeal of IRC section 415(e);
2. Amendments to IRC section 401(a)(16) to allow plans that are in full funding to pay excess plan benefits; and
3. Amendments to IRC section 420 to improve the access to and useability of provisions that allow plans that are in full funding to pay retiree health benefits.

(1) Repealing IRC section 415(e) is a key component to simplifying the administrative burden on corporate plan sponsors and would enhance incentives to maintain qualified pension plans. 415(e) coordinates the maximum benefits payable to an individual from a combination of pension and savings plans maintained by the same plan sponsor. In order to calculate whether or not a benefit is limited by 415(e), the plan sponsor must maintain records detailing pay, employee and employer contributions to savings plans, etc., for each year of the individual's employment. Keeping (and maintaining the integrity of) this data can be an enormous burden on employers. Further, the limit is inequitable in that it favors employees who have worked for multiple employers over those with stable employment. In legislation leading up to the Tax Reform Act of 1986, a 15% excise tax on excess distributions was proposed as a replacement for 415(e). The 15% excise tax was adopted, but 415(e) was not repealed. Subsequent events (such as the imposition of reduced limits under IRC section 401(a)(17) on compensation that can be used to calculate plan contributions and benefits) have further served to reduce the number of occasions that 415(e) will apply, but have not reduced the administrative burdens it imposes. Since actual limitation of benefits by 415(e) is rare, repeal of the limit is unlikely to generate significant tax revenue losses.

(2) Allowing plans that are in full funding to pay excess plan benefits would further simplify the administration of maximum benefit limits for sponsors of nondiscriminatory pension plans that are in full funding. Sponsors of these plans would be allowed to secure the provision of nondiscriminatory benefits (e.g., for disabled employees or retirees under early retirement incentive programs) that would otherwise be provided outside the pension plan (e.g., under a 415 excess plan) by paying benefits directly from the plan. This raises tax revenues, since benefits paid from accumulated pension assets would not generate a tax deduction, while benefits paid from an excess plan do generate a tax deduction. It also gives pension decision makers an incentive to better fund the pension plan so that benefits will be more secure.

(3) The proposed changes to IRC section 420 would give further incentives for maintaining a fully funded plan by extending and expanding the ability of plan sponsors to use any extra assets that arise to pay retiree medical benefits that would otherwise be paid directly by the company. This also raises tax revenues, since the benefits would not be deductible when paid from accumulated pension assets, whereas when paid directly by the sponsor a tax deduction is generated.

In summary, the proposal will reduce administrative costs for all qualified pension plans and enhance the benefit security of nondiscriminatory benefits. By reducing administrative burdens and increasing the attractiveness of maintaining a well funded pension plan, the proposal helps to preserve and promote the private pension systen.

DETAILED EXPLANATION

1. REPEAL IRC SECTION 415(e)

Description
IRC section 415(e) would be repealed. Section 415(e) was adopted in 1974 as a part of ERISA. In theory, it ensures that the tax advantages of tax qualified pension plans are not overused by any individual by imposing limits on the combination of pension and defined contribution plan benefits that a company can provide to any individual. However, in practice, 415(e) is a clumsy and administratively burdensome approach that requires extensive recordkeeping by plan sponsors. For instance, to calculate whether a benefit reduction under 415(e) would apply, a plan sponsor must keep and maintain the integrity of data showing, for each employee, pay for each year of employment, as well as contributions by both employers and employees to a variety of savings plans, ESOPs, etc. The situation can be further complicated when companies merge or transfer employees between operations that are subsequently sold. In recognition of the administrative burden, the legislation leading up to the Tax Reform Act of 1986 initially proposed a 15% excise tax on excessive distributions from tax qualified plans to replace 415(e). The 15% excise tax was adopted, however, without repeal of 415(e).

Revenue Impact
The proposal is likely to be scored as a revenue loser. However, IRC section 401(a)(17) limitations on compensation that can be taken into account for benefits and contributions to qualified plans, the extensive nondiscrimination rules in the IRC, and the IRC section 415 limits on contributions paid to and benefits paid from qualified plans, taken in combination, already constrain benefits sufficiently so that benefits generally are limited before 415(e) applies. Hence, any lost revenue should be small.

Supporting Arguments

- Simplification - reduces administrative problems in tracking annual additions for the total career of an employee. Under the proposal, data requirements will be reduced to data the employer can control (electronically) with reasonable accuracy.
- Other IRC limits on benefit payments mean that 415(e) is less likely to apply. Thus, the proposal would remove the administrative burden of maintaining data to calculate what is becoming an increasingly rare reduction in benefits.
- Improves equity by eliminating a current law bias against employees whose benefits are derived from a single employer.
- Enhances benefit security for employees whose benefits become payable from the trust.

2. AMEND IRC SECTION 401(a)(16) TO ALLOW PLANS IN FULL FUNDING TO PAY EXCESS 415 BENEFITS FOR CURRENT RETIREES

Description
A company would have the option to pay benefits above the IRC section 415 limits from the pension plan trust to retirees if the plan: 1) is fully funded (including liabilities assumed for excess benefits) for the year that the sponsor sweeps in the excess benefits, and 2) the benefits are based on a nondiscriminatory formula. For this purpose it is anticipated that the benefit formula would pass either a safe harbor or the general amount test under 401(a)(4).

Once benefits are payable from the trust, they would become a permanent liability of the plan. For funding purposes, however, the possibility of future "sweep-ins" could not be taken into consideration. As of the first plan year for which a plan adopts the provision, existing retirees would be allowed to elect whether benefits would be paid from the pension plan, or continue to be paid by the corporation. In subsequent years, new retirees would be given the opportunity to make a similar election. This means that less highly paid retirees that are affected by 415 (e.g., disabled employees or retirees under early retirement incentive programs) would be most likely to be afforded the increased benefit security of receiving benefits from the qualified pension plan. Very highly compensated individuals would only be able to get the increased benefit security by paying any excise tax on excess distributions from qualified pension plans.

<u>Revenue Impact</u>
Raises revenue for U.S. Treasury in the near term because benefits currently being paid from the company are tax deductible; benefits paid from the pension trust are not.

The proposal will reduce the amount of current pension fund accumulations, and this amount will likely need to be made up in the future. Thus, over the long term, current Treasury revenues are increased at the expense of future revenues for ongoing plans.

Finally, the PBGC is not likely to be put at risk, since the plan must be in full funding to use the provision, and the general impact of the proposal will be to encourage full funding of plans.

<u>Supporting Arguments</u>
- Already a precedent in the IRC 420 transfer provisions.
- Provides benefit security to retirees.
- By increasing executive and other decision makers' interest in making sure that the plan is well funded, it should help to increase benefit security for active employees and decrease the long term risks of the PBGC.

3. MAKE SIGNIFICANT IMPROVEMENTS TO IRC SECTION 420

<u>Description</u>
Under current law, sponsors have the ability to use excess pension fund assets to pay retiree health benefits. To do so, the sponsor's pension and retiree health plans must meet certain requirements, including: pension assets must exceed 125% of current liability; all pension plan participants must be vested in their accrued benefits; the employer must agree to maintain the current level of health plan contributions for at least 5 years; and the amount transferred cannot exceed one year's claim payment. The law currently has a sunset provision, so that transfers will not be available for plan years after 1995. Few plan sponsors have used the section 420 transfer rule because of the administrative costs and an unwillingness to make such a large commitment in exchange for a short-term cash flow advantage.

The proposal would:
- Extend the sunset date of the provision through the year 2000;
- Remove the 5 year maintenance of health care claims cost rule; and
- Remove the requirement to vest all pension plan participants.

Alternatively, if health care reform legislation is enacted, excess assets could be used:
- To pay any employer toll that is levied on employers in lieu of or in addition to any employer obligations for retiree health benefits.

<u>Revenue Impact</u>: Should raise significant amounts of revenue.

<u>Supporting Arguments</u>
- Many more employers will take advantage of the program than currently. This should significantly raise tax revenues.
- Faced with the inability to use pension money to pay retiree benefits, several employers have canceled their retiree medical plans, including plans affecting either future or present retirees. If companies could use excess pension money, more retirees would continue to receive a benefit.
- Past experience under the program indicates that abuse is unlikely.

THE ERISA INDUSTRY COMMITTEE — ATTACHMENT C

ERIC CROSS-TESTING PROPOSAL

SUMMARY

Background:

In order for an employee pension or profit-sharing plan to be tax-qualified, the Treasury's nondiscrimination regulations provide that either the amount of the benefits provided by the plan or the amount of the contributions made to the plan must not discriminate in favor of highly compensated employees. "Cross-testing" is the term used when a defined contribution plan is tested for nondiscrimination on the basis of the benefits provided, rather than on the basis of contributions made. Cross-testing frequently is used when the contributions to a defined contribution plan increase as either the age or the length of service of the employee increases. Cross-testing also is used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis for nondiscrimination purposes.

The Administration's Bill:

The Administration's pension funding and PBGC reform bill (H.R.3396/S.1780) prohibits defined contribution plans other than target benefit plans from testing for nondiscrimination on the basis of benefits rather than on the basis of contributions (i.e., prohibits defined contribution plans from cross-testing). The Administration proposed the amendment because the Treasury Department believes the cross-testing provisions of the Treasury's regulations allow defined contribution plans to make allocations that unduly favor highly compensated employees.

ERIC's Proposal:

If legislation curbing the use of cross-testing is enacted, ERIC proposes to modify the Administration's ban in order to allow nondiscriminatory defined contribution plans to continue to use cross-testing. ERIC's amendment would allow a plan to be cross-tested if the plan first passes either of two "gateway" tests. The gateways ensure either (1) that each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees or (2) that the disparity between allocation rates for highly compensated and non-highly compensated employees under the plan is reasonable.

A plan that passes either of these gateways differs significantly from the plans the Treasury has regarded as abusive.

DETAILED EXPLANATION

Background:

In order for an employee pension or profit-sharing plan be tax-qualified, the Treasury's nondiscrimination regulations provide that either the amount of the benefits provided by a plan or the amount of the contributions made to the plan not discriminate in favor of highly compensated employees. In practice, most defined benefit plans are tested according to the benefits provided by the plan, and defined contribution plans are tested according to the contributions made to the plan.

In some cases, however, a defined contribution plan is tested on the basis of the benefits provided. The process of showing that the benefits provided under a defined contribution plan are nondiscriminatory is referred to as "cross-testing".

Cross-testing frequently is used when the contributions to a defined contribution plan increase as either the age or the length of service of the employee increases. Cross-testing also is used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis for nondiscrimination purposes. Employee stock ownership plans (ESOPs), cash or deferred (§401(k)) arrangements, and employer matching (§401(m)) plans may not be cross-tested under the nondiscrimination rules on an individual plan basis, but may be cross-tested where the plan is aggregated with a defined benefit plan in order to test the plans on an aggregated basis.

The Administration's Bill:

The Administration's pension funding and PBGC reform bill (H.R.3396/S.1780) prohibits defined contribution plans other than target benefit plans from testing for nondiscrimination on the basis of benefits rather than on the basis

of contributions (i.e., prohibits defined contribution plans from cross-testing).

The Administration proposed the amendment because the Treasury Department believes the cross-testing provisions of the Treasury's regulations allow defined contribution plans to make allocations that unduly favor highly compensated employees. However, the Treasury has stated that many plans that use cross-testing are nondiscriminatory, and has invited the public to suggest proposals that would allow "nonabusive" plans to continue to use cross-testing.

ERIC's Proposal:

ERIC's proposal would modify the Administration's proposal in order to allow nondiscriminatory plans to continue to use cross-testing. ERIC's proposed amendment would allow a defined contribution plan to be cross-tested (that is, tested on a benefits basis) if the plan first passes either of two "gateway" tests. The gateways ensure either (1) that each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees or (2) that the disparity between allocation rates for highly compensated and non-highly compensated employees is reasonable. (See *Gateway #1* and *Gateway #2*, below).

ERIC's proposal also modifies a statement in the Administration's explanation of its bill that would restrict the ability to use benefit amounts calculated through cross-testing in meeting the average benefit percentage test of the nondiscrimination regulations (see *Special Rule*, below).

Under ERIC's proposal, the legislative history should state that no inference shall be drawn regarding the validity of the Treasury's nondiscrimination and coverage regulations.

Gateway #1: Under ERIC's amendment, a plan will pass the first gateway if each of the allocation rates under the plan does not unduly favor the employer's highly compensated employees. Under the amendment, the plan will meet the first gateway if the percentage of non-highly compensated employees who benefit from each of the plan's allocation rates is greater than or equal to the unsafe harbor percentage in the Treasury's coverage requirements (see Treas. Reg. §1.410(b)-4(c)).

For example, suppose that an employer has 500 nonexcludable employees, 100 of whom are highly compensated. If all 500 employees participate in the employer's profit-sharing plan, and 25 of the highly compensated employees receive an employer contribution equal to 10 percent of pay, the plan will not pass this gateway unless at least 25 of the non-highly compensated employees receive an employer contribution of 10 percent of pay or more. A plan's failure to meet this gateway by *de minimis* amounts will be disregarded, as long as the failures are infrequent.

Gateway #2: A plan will pass the second gateway if it meets two requirements. The first requirement is that the average allocation rate for the non-highly compensated employees who participate in the plan be at least 70 percent of the average allocation rate for the highly compensated employees who participate in the plan. The second requirement is that the highest allocation rate for any highly compensated employee under the plan not exceed by more than 5 percentage points the average allocation rate for all of the plan's non-highly compensated employees.

For example, if the average allocation rate for the highly compensated employees who participate in the plan is 10 percent of pay, the first requirement is met only if the average allocation rate for the non-highly compensated employees who participate in the plan is at least 7 percent of pay. If the average allocation rate for the non-highly compensated employees is 7 percent of pay, the second requirement is met only if no highly compensated employee receives an allocation of more than 12 percent of pay.

For purposes of applying the second gateway, the only employees taken into account are those employees who participate in the plan. In addition, in applying both gateways, the plan may impute disparity in contributions to the extent permitted by the current nondiscrimination regulations.

Special Rule: Under the Treasury's current rules, a plan must pass one of two coverage tests: a ratio percentage test or an average benefit percentage test.[1] The Administration's explanation of its bill refers to a statutory change that would affect plans that use the average benefit percentage test. The change would prohibit an employer that applies the average benefit percentage test from determining employee benefit percentages on a benefits basis unless a substantial portion of the employer-provided benefits is provided under one or more defined benefit plans. The Administration's proposed bill, however, does not appear to include this provision.

ERIC proposes that, if this provision is included in any legislation that is enacted, it be revised to permit an employer to take the contributions under a defined contribution plan into account in meeting the average benefit percentage test on a benefits basis if the contributions (i) are nondiscriminatory in amount (i.e., on a contributions basis), (ii) satisfy either of the gateways that ERIC has proposed, (iii) are made to a target benefit plan, (iv) are made under §401(k) and meet the special nondiscrimination requirements that apply to §401(k) plans, or (v) are employer-matching contributions and meet the special nondiscrimination requirements that apply under §401(m) to employer-matching contributions.

No Inference: Cross-testing is a procedure provided for in Treasury regulations. If an amendment is enacted limiting the use of cross-testing, the legislative history should state that no inference shall be drawn from the amendment regarding the validity of the Treasury's nondiscrimination and coverage regulations.

Conclusion:

A plan that passes either of ERIC's proposed gateways differs significantly from the plans that Treasury has regarded as abusive. By meeting one of the gateway tests, a plan demonstrates that it provides nondiscriminatory contributions to the employer's non-highly compensated employees, and it is therefore appropriate to permit the plan to demonstrate that it provides benefits that are nondiscriminatory in amount.

Similarly, a plan that meets any one of the requirements of the proposed special rule has already met other tests that demonstrate that the plan is nondiscriminatory, and it is therefore appropriate to permit the employer to aggregate that plan with others to demonstrate that the employer's plans provide benefits that are nondiscriminatory in amount.

---

[1] Under the coverage requirements set out in Internal Revenue Code §410(b), a plan must meet either of two tests: a "ratio percentage test" or an "average benefit percentage test". A plan meets the ratio percentage test if (1) 70% of the employer's non-highly compensated employees participate in the plan or (2) if the percentage of non-highly compensated employees participating in the plan is at least 70% of the percentage of highly compensated employees participating in the plan. A plan meets the average benefit percentage test if (1) the plan benefits a nondiscriminatory classification of employees (as determined by regulation) and (2) the average benefit as a percentage of pay for the non-highly compensated employees is at least 70% of the average benefit as a percentage of pay for the highly compensated employees.

Prepared Statement of Senator David Pryor

Mr. Chairman, I would like to thank you for holding this hearing to examine the problem of underfunded private pension plans and possible reforms to correct the problem.

I would also like to thank Secretary Reich for his leadership in appointing the interagency task force which has studied this complex problem and come up with some very specific recommendations to battle this problem.

At the hearing before the Finance Subcommittee on Private Pension Plan on this matter in September of 1992, the former Executive Director of the PBGC was quite outspoken and insistent that we were facing the next "S&S Crisis." Much of the discussion that day addressed the truthfulness of that assertion.

Today, I am gratified that the new PBGC Executive Director, Marty Slate, has toned down the sensationalism offered by his predecessor, and instead, come to us with a dose of realism as to the problem we face and with specific proposals to address the problem.

The mission of the PBGC is to furnish security and confidence to workers with pension plans. If the PBGC questions the adequacy of those plans in a overly sensational manner, then workers understandably get scared, and instead of providing security and confidence, the government causes fear and confusion.

I believe the current approach creates the best environment for constructive change, and I commend Director Slate for his effort.

As I understand it, the problem of underfunding is concentrated in a small number of financially troubled industries most of which are represented here today. As many of these companies are struggling to come out of difficult times by reinvesting in their businesses, the Administration's proposal asks them to pay more into their pension plans. I am interested in both the companies' and the Administration's assessment of how much more we are asking the companies to pay, and the impact these additional costs will have on their future viability. In general, the Administration's proposals asks these companies to pay more by (1) requiring these underfunded plans to pay more in PBGC premiums and (2) paying more into their underfunded plan. I might add that these two basic methods of addressing the problem are not mutually exclusive. Under the proposal, by limiting the flexibility of actuarial assumptions in determining the underfunded amount, the calculation of the PBGC premium amount will experience a corresponding increase.

I am interested in this dynamic of the proposals because, once we determine how much more these companies can and should pay, we must ask "where will these fund go?—to the PBGC or into the underfunded plan?" I am sure there is a proper balance, and I hope we can discuss this aspect of the proposals today.

Most every person, organization, or business I talk with about this problem do not question whether to act, but rather they question how to act. This is illustrated by proposals offered by the private sector which address the problem. I would like to recognize and commend the ERISA Industry Committee for coming forward with their proposal to address this problem, and I look forward to hearing their views today.

With consensus that we do have a problem, and with some very sound and reasonable proposals on the table to fix it, I hope we can move forward quickly to address the retirement security needs of millions of American workers.

Testimony of Robert Reich
Secretary of Labor
Before the
Committee on Finance
United States Senate

June 15, 1994

Executive Summary

The Administration is determined to take all necessary steps to keep the pensions of workers and retirees safe and secure. The Retirement Protection Act is a comprehensive, balanced, and reasonable approach to the serious problem of pension underfunding that could threaten retirement security.

Most pension plans are well funded, but there is serious underfunding in certain industries. Underfunding doubled in the last six years, climbing to $53 billion in 1992. This presents an unacceptable risk for workers and retirees, particularly the 1.2 million people in plans of financially troubled companies. If their plans should terminate, they may lose benefits not covered by the PBGC guarantee. These underfunded plans also pose a risk to the PBGC, where the deficit now approaches $2.9 billion. Current law is not working.

Recent additional contributions by companies are not a cure. Pension underfunding is a chronic problem that will not go away without strong legal reform.

This legislation will strengthen our defined benefit pension system and improve PBGC's ability to protect it. At the same time, these reforms have been carefully crafted to be affordable. The Act will protect the pension benefits of American workers and retirees, while at the same time allow companies to continue in business, provide jobs, and contribute to the economy.

Now is the time to enact the pension reforms of the Retirement Protection Act. The growing trends in underfunding and the PBGC deficit are clear and irrefutable - and must be reversed. It is simple common sense to deal with these problems while they are still manageable. The forward movement in the economy presents us with a special opportunity to put our pension system on a sound footing.

Testimony of Robert Reich
Secretary of Labor
Before the
Committee on Finance
United States Senate
June 15, 1994

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the Administration's pension reforms to assure retirement security for America's workers and retirees. This is indeed the time for reform.

When this Administration came to office, we heard the concerns that had been raised about the health of the pension system. I immediately appointed a high-level interagency Task Force to take a hard, careful look at the issue of benefit protection. The group worked intensively through 1993, defining the dimensions of the problem and the most effective way to address it.

We in the Administration are determined to take all necessary steps to keep the pensions of workers and retirees safe and secure. The Administration's legislative package, the Retirement Protection Act, is a comprehensive, balanced, and reasonable approach to the serious problem of pension underfunding that could threaten retirement security.

My message is simple. We should reform the system now. Our solutions, if pursued now, are reasonable and affordable. If we wait, the medicine that will be necessary will only be harder to swallow. The forward movement in the economy presents us with a special opportunity to put our pension system on a sound footing.

Mr. Chairman, this Committee has consistently led the way in assuring a sound retirement system for our nation's workers. Your leadership on this most important legislation is invaluable.

I. INTRODUCTION

We are approaching the 20th anniversary of the Employee Retirement Income Security Act of 1974 (ERISA), the anchor of our private pension system. In those 20 years, the private pension system has become a true American success story. Thanks to ERISA, millions of hard-working Americans have gained pension coverage, and those who were already covered have found that the promise of a benefit upon retirement has become a reality.

The PBGC plays an important role in safeguarding the nation's retirement system. The mainstay of our private retirement system is the defined benefit pension plan, the kind that offers set benefits to workers. The agency stands behind the promises of defined benefit plans and assures that most benefits will be paid to the workers who depend on them. It guarantees the benefits of 41 million workers and retirees in more than 65,000 pension plans. Today more than 346,000 people rely upon PBGC for their pensions. Those who are in our trust will continue to receive their benefits. For them as well as for others, we must keep the PBGC on a sound footing.

II. THE PROBLEM

Most of the pension plans insured by the PBGC are well funded. The retirement system is a strong one, but there are growing chinks in the armor. Underfunding of pensions is persistent. In the last few years, underfunding has nearly doubled - from $27 billion in 1987 to $53 billion in 1992. This chronic underfunding can undermine our retirement system.

It is important to note that underfunding is concentrated in a few industries such as steel, automobile, tire manufacturing, and airlines.

Underfunding poses an unnecessary and unacceptable risk for workers and retirees. If their plans should terminate, they may lose benefits not covered by the PBGC guarantee.

These underfunded plans also pose a risk to the PBGC. PBGC's deficit now approaches $2.9 billion, and it is moving us in a direction that could have significant consequences. Indeed, the deficit has doubled in the last five years. At the same time, the insurance program - with more than $8 billion in assets - is not in immediate danger. Because PBGC's payments are spread out over many years, it can continue paying benefits for a long time. So long as chronic underfunding persists, however, the long-term health of the nation's pension system - and the insurance program that protects it - is uncertain.

III. REFORM NOW

Underfunding will not disappear of its own accord. Much of the build-up in underfunding is due to too much flexibility in our funding rules for those who wish to minimize contributions. Some employers, in fact, operating within the framework of current law, have been able to take contribution holidays even though their plans are severely underfunded. Underfunding will continue unless we close the avenues for companies to legally avoid their funding responsibilities.

In recent weeks, there has been positive news on pension funding. With encouragement from the PBGC, some companies have announced their intention to make additional pension contributions. This is to be applauded. Additional intermittent contributions will help, but they do not assure a cure. Underfunding is chronic and persistent, and it will continue unless there is systematic legal reform.

Now is the time to enact the pension reforms of the Retirement Protection Act. The growing trends in underfunding and the PBGC deficit are clear and irrefutable -- and must be reversed. It is simple common sense to deal with these problems while they are still manageable. We cannot stand by and watch while the situation worsens.

IV. RETIREMENT PROTECTION ACT

The Retirement Protection Act is the product of a task force I established last year to address the concerns about benefit security and the PBGC. The comprehensive reforms we propose would mandate faster and more certain funding and would guarantee increased contributions to underfunded pension plans. If enacted, this legislation will eliminate the problem of chronic underfunding.

The legislation is designed to fix only what is broken. Fully funded plans would not be affected by our major reforms.

These reforms are carefully crafted to be affordable. The Act will protect the pension benefits of American workers and retirees, while at the same time allowing companies to continue in business, provide jobs, and contribute to the economy.

Funding

Strengthening the funding rules is the heart of our reform package. Current law permits as long as 30 years in some instances for companies to fund promised benefits. Given business realities, that is simply too long. We accelerate contributions to underfunded plans and eliminate the wiggle room that employers now have to avoid funding their plans. This should result in most new benefits being funded over five to seven years.

It is especially important that we require companies with underfunded plans to use realistic actuarial assumptions in determining funding. Companies with large amounts of underfunding have taken liberties with the flexibility now in the law to take contribution holidays.

At the same time, we want companies to move forward with their business. Thus, we have included in the legislation a special transition rule to protect employers from extraordinary increases in their annual contributions for up to seven years.

PBGC Compliance Authority

Stronger funding rules will not solve the whole problem. All too often we have seen companies undertake business transactions that endanger pension promises. For instance, a healthy corporation might sell off a subsidiary in poor health with an underfunded pension plan. Breaking the corporate tie can cut off the plan's only source of funding.

The reforms would give the PBGC the tools to enforce the law effectively and to assure that large employers remain responsible for their pension promises. Our proposals would require companies with large underfunded plans to provide PBGC with advance notice of certain transactions. When these transactions threaten the long-term health of pensions, PBGC would be allowed to apply to the federal courts for meaningful remedies. The proposals are carefully tailored to assure the continued pace of corporate transactions.

Premiums

To further encourage better funding, we propose to phase out the cap on the variable rate premium paid by sponsors of underfunded plans. Plans that pose the greatest risk should pay their fair share. Companies with 80 percent of the underfunding now pay only a quarter of PBGC's total premium income. Under this proposal, they would pay half.

Participant Assistance

Finally, we will require employers with underfunded plans to provide their workers - in plain language - an explanation of their underfunded pension plan and the limits of PBGC's guarantee. Workers have every right to know whether their pensions are at risk. Only then can they make informed choices about their retirement and their future.

V. CONCLUSION

This is a strong, integrated package, carefully crafted to solve an identifiable problem. We need these reforms because current law simply is not working. Pension underfunding has swollen substantially since 1987, and the legal loopholes are putting retirees and the American taxpayer at risk. The Retirement Protection Act takes a firm, balanced approach that will strengthen our defined benefit pension system and improve PBGC's ability to protect it. The reforms will help assure funding of all vested benefits within 15 years and, based on prior PBGC experience, are forecast to eliminate PBGC's deficit within 10 years.

The time to fix the retirement system is now. This can only be done with this Committee's leadership. The Administration stands ready to work with Congress to expedite passage of this important legislation.

88-738 O - 95 - 4

PREPARED STATEMENT OF LESLIE B. SAMUELS

Mr. Chairman and Members of the Committee: I am pleased to present the views of the Treasury Department on the Retirement Protection Act of 1993 (H.R. 3396). The Treasury Department actively participated in the Administration's PBGC Task Force and the Department strongly supports this package. We believe that this legislation addresses the primary causes of the recent trend of losses for the Pension Benefit Guaranty Corporation (PBGC) and that enactment of the legislation would reverse the trend of increasing PBGC deficits in a responsible manner, before the situation becomes a crisis. This morning I will discuss the portions of the bill that amend the Internal Revenue Code.

MINIMUM FUNDING REQUIREMENTS

The bulk of the amendments to the Internal Revenue Code in this legislation relate to the minimum funding rules that are found in section 412. These minimum funding rules are designed to ensure that employers sponsoring defined benefit plans set aside assets to secure the benefit promise made to their employees. In recognition of the long-term nature of the liabilities, the minimum funding rules permit employers to fund their commitment over a number of years.

The minimum funding rules enacted as part of the Employee Retirement Income Security Act of 1974 (ERISA) were amended in 1987. These amendments require an employer with over 100 employees that sponsors an underfunded plan to make an additional deficit reduction contribution designed to eliminate the underfunding more rapidly. In reviewing the effectiveness of these rules, the Administration's task force determined that some employers with significantly underfunded plans had used loopholes in the statute that allowed them to avoid making these additional deficit reduction contributions.

The bill modifies the deficit reduction contribution requirements in a number of ways in order to close the statutory loopholes that employers have exploited. First, the bill improves the coordination of the deficit reduction contribution and the regular minimum funding determinations. Under current law, the impact of actuarial gains and reductions in liability due to changes in actuarial assumptions (or in the other direction, the impact of actuarial losses and increases in liability due to changes in actuarial assumptions) is recognized twice in determining the deficit reduction contribution. The bill would end this double counting and effectively require the employer to make contributions based on the greater of the regular minimum funding requirement and a free-standing deficit reduction contribution.

Secondly, the bill mandates the use of certain standard assumptions for purposes of determining the amount of a pension plan's underfunding and the amount of the resulting deficit reduction contribution. The 1987 rules required the use of an interest rate within the corridor of 90–110% of the interest rate on 30-year Treasury bonds (averaged over the past four years) for this purpose. However, the 1987 rules did not require the use of any particular mortality table for this purpose. As a result, employers with poorly funded pension plans have had an incentive to use interest rates at the high end of the permitted corridor and to assume that their employees have higher than standard mortality (i.e., lower life expectancy). The use of high interest rates and mortality assumptions minimizes the amount of the apparent pension liability, reducing the required contributions.

The Retirement Protection Act would mandate that the interest rate used for purposes of determining the deficit reduction contribution be no greater than 100% of the 30-year Treasury rates (7.27% for plan years beginning in May 1994) and would require the use of the group annuity mortality table currently adopted by the insurance commissioners of at least 26 States. As the Members of this Committee know, this is the same mortality table specified in Internal Revenue Code Section 807(d)(5), relating to the determination of reserves for life insurance companies.

The bill would also tighten the deficit reduction contribution formula that determines the speed of funding new plan liabilities under the 1987 amendments. The new formula would require plans to fund substantially all of the increases in liability in the first 5–7 years after the amendment. Under current law, the liability can be funded at a rate that corresponds to 12 year amortization. This change will ensure that increases in liability from benefit changes will be funded over a period that more closely tracks the five-year phase-in of PBGC's guaranty.

Finally, in developing the proposal we attempted to anticipate how employers might try to avoid making deficit reduction contributions in the future, and then we closed these potential loopholes in advance. For example, the bill provides that employers sponsoring significantly underfunded pension plans (i.e., over $50 million of underfunding in the controlled group) would be required to obtain advance Internal Revenue Service approval of changes in actuarial assumptions that significantly

decrease their current liability. Thus, while these employers will be permitted to reflect their individual situations in establishing retirement age assumptions, for example, they would need to justify to the I.R.S. any changes in those assumptions from prior assumptions. This requirement, in conjunction with the use of a specified mortality table and a lower cap on the interest rate, will help ensure that employers cannot manipulate the plan's actuarial assumptions to avoid their responsibility to fund their benefit promises.

The Administration recognized that an abrupt increase in the minimum funding requirements may be overly burdensome for employers in the short term. Consequently, the bill includes transition rules that give short-term relief to employers, while still providing for steady, gradual improvement in plan funding.

QUARTERLY CONTRIBUTIONS AND NONDEDUCTIBLE CONTRIBUTIONS

As part of the process of reviewing the funding rules, the task force identified two other related provisions that we believed could be improved by narrowing the scope of their application: the quarterly contribution requirements and the excise tax on nondeductible contributions. I will discuss each of these provisions in turn.

The requirement that an employer make quarterly contributions to its pension plan (modeled on the payment of estimated income tax) was added in 1987 and provides an early warning signal for the PBGC that an employer may be unable to meet the minimum funding requirements for a year. In the absence of the quarterly contribution requirement, such an employer could wait until 201/2 months after the beginning of the plan year before coming to grips with its financial responsibility to the plan. By requiring quarterly contributions, and notice to the PBGC and plan participants of an employer's failure to pay these installments, the funding rules force the employer to face up to its problems earlier in the year.

The quarterly contribution rules also are beneficial in the situation where the employer's financial problems first appear later in the plan year. In this case, if the employer has been making the required quarterly installments a plan will have been at least partially funded during the portion of the year prior to the development of the financial problems.

On the other hand, the requirement that an employer contribute four times a year, together with the need to have an actuary determine the minimum installments, adds an administrative burden for an employer. If a plan currently has assets in excess of its current liability, the Task Force concluded that the administrative burden on employers outweighs the benefit of quarterly installments to the employees and the Government. This is particularly true for plans near the full funding limit, where an employer that must make a quarterly contribution before the actuarial valuation is complete may ultimately discover that the contribution is nondeductible. For these reasons, the bill would eliminate the quarterly contribution requirement for plans that had assets in excess of current liability in the previous year.

The purpose of the excise tax on nondeductible contributions is to discourage employers from making these contributions in order to transfer assets into the plan's tax-exempt trust. In the two situations described in the bill, we believe that the employer's nondeductible contributions are not motivated by a desire to obtain excessive tax shelter, but are primarily a result of non-tax considerations, and should not generate an excise tax. These situations arise where: (1) an employer with 100 or fewer employees contributes an amount to its pension plan to fund the current liability and then terminates the plan, or (2) an employer sponsoring a defined benefit plan also sponsors a section 401(k) plan with overlapping coverage that is receiving employee salary deferrals or employer matching contributions totaling less than 6% of compensation. In the former case, a small employer may be required to make the nondeductible contributions as a condition of plan termination. The latter case deals with the anomalous situation where an employer wishes to make additional contributions in order to decrease plan underfunding, but is now discouraged from doing so because employees are electing to make salary deferrals in a 401(k) plan that count against the employer's aggregate qualified plan deduction limits.

ACTUARIAL EQUIVALENCE

The bill makes minor changes to the actuarial equivalence rules used for purposes of converting annuities to nonannuity distributions, primarily lump sums, under sections 417(e) (restrictions on cash-outs) and 415(b) (maximum permitted benefits). Under current law, the actuarial equivalence that can be used for these purposes is based on two different interest rates (one of which is tied to the PBGC interest rates used to value terminated plans, the other of which can be as low as 5%) and no specified mortality table. The bill would specify a single interest rate and mortal-

ity table for both purposes. Eliminating the current cross-reference to the PBGC interest rates will also enable the PBGC to adjust the interest rate it uses for other purposes in the future without also affecting the benefits of participants in all plans.

NONDISCRIMINATION AND CROSS-TESTING

As a condition of tax-favored treatment, section 401(a)(4) requires that retirement plans demonstrate that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. Under current law, this demonstration can be on the basis of either contributions or benefits, without regard to whether the plan is a defined contribution plan or a defined benefit plan.

Section 408 of the bill would generally prohibit the practice known as "cross-testing" a qualified defined contribution plan. The bill would generally require defined contribution plans, and aggregations of defined contribution and defined benefit plans, to demonstrate nondiscrimination on the basis of actual plan contributions, as opposed to projected benefits at retirement.

Cross-testing a defined contribution plan is needed when plans provide different allocations, as a percentage of compensation, to different employees. If the employees receiving larger allocations are older than the other employees, the difference may be justified by looking at the equivalent benefits those allocations are projected to generate. While some argue that cross-tested defined contribution plans merely make explicit the age-bias that is implicitly found in traditional defined benefit plans, there are significant differences between these types of plans. For example, the amount of benefit an employee receives from a defined benefit plan does not depend on the investment return in the fund; and the delivery of that benefit is further guaranteed by the PBGC. However, employees in a cross-tested defined contribution plan bear investment risk. An employee will receive the hypothetical benefit that is used to satisfy the nondiscrimination rules only if the plan's investment return and the conversion of the employee's account balance into retirement income actually match the assumptions used in the projection.

Creative practitioners have recently gone further than merely mimicking the distributional aspects of defined benefit plans by relating allocations to age. They have developed aggressive plan designs that provide significantly higher contributions for one class of employees (such as the owners of a business) than for the rest of the employees. If most of the favored class is older than the other employees, as is often the case in these situations, cross-testing may be used to satisfy the nondiscrimination rules in an inappropriate way.

The potential for highly-compensated employees receiving substantial benefits in cross-tested plans has received considerable press attention. For example, discussions of cross-testing have made their way into the Wall Street Journal, Pension World and Financial Planning magazine. These articles emphasize the potential for highly-compensated employees to maximize benefits for themselves while minimizing contributions for rank-and-file workers. For example, a June 1993 Financial Planning article is headlined "Skewed retirement plans help owners at workers' expense." The Wall Street Journal article leads with the question "Is it a retirement plan, or a tax shelter?" An article in the March 1994 Journal of the American Society of CLU and ChFC contains an illustration of an employer using cross-testing to reduce the allocations for rank-and-file workers from 15% of pay to 3% of pay, while the owner continues to receive an allocation of $30,000. I have attached copies of a small collection of these articles for the record.

The Administration is concerned that such practices and the increasing attention that they have been receiving, can

- reduce the share of tax-subsidized retirement funds that benefit rank-and-file workers
- encourage employers to abandon the defined benefit system, thus eroding the PBGC premium base
- discourage the hiring of older rank-and-file workers (to the extent that the Age Discrimination in Employment Act doesn't protect these workers), and
- generally have a detrimental impact on the public's perception of the integrity of our tax-favored retirement system.

For these reasons, the Administration continues to support restricting cross-testing.

Let me emphasize that this proposal was developed because some employers are manipulating the cross-testing rules in order to obtain a tax subsidy for retirement plans that provide excessive contributions to highly compensated employees, at the expense of rank-and-file workers. Since the Administration proposed limiting cross-testing, we have heard from and met with a number of interested groups. The purpose of our meetings with these representatives has been to identify the types of

plans that provide meaningful benefits to rank-and-file workers, in contrast to the abusive cases. We have received some useful suggestions in this regard.

We hope that we can work with the Committee in tailoring the proposal to target the troublesome cases. In this process, however, our guiding principle remains—the abusive practices must stop.

ROUNDING RULES FOR INDEXED VALUES

Many of the statutory dollar thresholds and limits used in the qualified plan area are indexed to changes in the cost of living. For example, the annual limit on contributions under section 401(k) is $9,240 in 1994 (increased from $8,994 in 1993). The bill would change the indexing rules so that the indexed values for a year are available before the start of the year and would provide for rounding of these indexed values to the next lowest multiple of $500 or $5,000. The earlier determination of the indexed values and the use of rounded values would simplify administration by employers and communication with employees, because the indexed values would not necessarily change each year. The proposal also has the effect of raising revenue to offset some costs of the bill. As the Members of the Committee know, a similar rounding rule was adopted in last year's reconciliation bill for the compensation limit of section 401(a)(17).

CONCLUSION

In conclusion, I would like to emphasize that now is the time to act, while the PBGC's problems are still manageable. Although the PBGC has assumed significant liabilities over the past ten years from the termination of underfunded plans, PBGC's responsibility for benefit payments under those plans is spread out over a number of years. Enactment of the Retirement Protection Act of 1993 will require employers sponsoring defined benefit plans to do a better job of living up to their commitments by adequately funding their plans, thereby reducing PBGC's potential liability.

"New Comparability": Increased Flexibility for Profit Sharing Plans?

EDWARD F. LONDERGAN
PAUL VICKERS, ChFC, FLMI

Abstract: *The ability of employers to develop increasingly flexible qualified retirement plans has evolved from integrated allocation plans to age-weighted plans, and now, to "new comparability" plans. In the authors' view, new comparability gives employers an opportunity to make the bulk of their retirement plan contributions to key employees — and still pass nondiscrimination tests. The authors show that they believe new comparability is even more flexible than age-weighting. They also note that pending legislation could affect the use of new comparability, but that the fate of the legislation is unknown at this time.*

While recognizing the advantages of profit sharing plans, many employers would prefer to have more control over the benefits they provide. Many plan sponsors, for example, would like to be able to design a plan that is flexible enough to reward key employees — those who contribute most to profits. Businesses that offer their employees a 401(k) plan often are looking for a supplemental plan that allows them to maximize their own annual contributions without giving up tax advantages.

A profit sharing plan design called "new comparability" gives many employers the flexibility to structure their profit sharing plans to meet these and other needs. New comparability allows many employers to contribute the maximum $30.000 a year for themselves and the minimum three percent of pay for other employees — and still pass nondiscrimination tests. In other words, new comparability plans are nearly as flexible as nonqualified plans, but offer the tax benefits of qualified plans.

Unless an employer receives a greater financial benefit from a profit sharing plan than he or she would receive by simply including the money as taxable earnings, the employer is unlikely to go to the trouble of establishing a plan. That's why, for as long as profit sharing plans have existed, planning experts have searched for designs that maximize the percentage of contributions allowed for preferred employees, while still meeting the criteria necessary for a plan to qualify for federal tax benefits. To be qualified, the plan has to pass tests that determine whether it discriminates against non-highly-compensated employees.

So the challenge to plan designers is to develop plans with seemingly contradictory goals — the plan has to pass nondiscrimination tests while at the same time providing the bulk of the plan benefits to highly-compensated employees.

The first design to address this challenge was the integrated allocation plan, which takes social security contributions into account in calculating contributions on after-tax income. Integrated plans proved effective until the Tax Reform Act of 1986 became law. Before the Tax Reform Act, a spread of 30 percent was allowed between contribution rates for highly-compensated and non-highly-compensated employees. The Act reduced the allowable spread to 5.7 percent.

Age-Weighted Plans

The next major advance toward achieving employer goals came when regulations for Section 401(a)(4) of the Internal Revenue Code were issued in 1991. These regulations, which are more than 600 pages long, allow defined contribution plans, including profit sharing plans, to base nondiscrimination testing on benefits provided at retirement instead of on annual contributions.

As a result of the new regulations, many employers are allowed to "age weight" their plans — an advantage previously allowed only with defined benefit plans. Defined benefit plans have decreased in popularity, especially among small employers, because of their lack of flexibility, and because the proliferation of regulations in recent years has made them administratively burdensome.

This issue of the Journal went to press in January 1994

New comparability gets its name because it gives employers a new way to compare groups of employees for nondiscrimination testing.

Age-weighting gives employers the ability to make contributions based on the concept that older employees should receive larger contributions each year, because they are closer to retirement and therefore have a shorter funding period. Because the business owner and key executives often are older than other employees, age-weighting allows the plan to be designed to favor them. Understanding new comparability requires an understanding of age-weighting because it is based on the same concept and is even referred to by some experts as "advanced age-weighting."

Age-weighted plans test for nondiscrimination based on benefits provided, instead of contributions allocated. First, the allocation for each participant is projected to retirement age at a reasonable rate of interest (8.5 percent is typically used). The resulting lump sum is converted to an annuity, based on reasonable assumptions (i.e., 8.5 percent interest and UP-84 mortality). The annuity is expressed as a percentage of compensation, which is called the "equivalent benefit accrual rate," or EBAR. The EBAR is then used for all discrimination testing.

Consider, for example, a 55-year-old with a $100,000 salary and a $20,000 annual account addition this year. Projecting $20,000 at 8.5 percent interest for 10 years, assuming a retirement age of 65, yields $45,220. It takes $10.48 at 8.5 percent interest to create annual income of $1, so the employee's annual income from the plan is $45,220/$10.48, or $4,314.85. Since his salary is $100,000, his EBAR is $4,314.85/$100,000, or 4.31 percent.

When EBARs are used for discrimination testing, older employees receive larger annual contributions as a percentage of pay, since their EBAR is based on fewer years of earnings growth. Before age-weighting was allowed, an employer approaching retirement conceivably had to contribute more to younger employees' retirement plans over their careers than to his or her own account, since the employer would receive benefits for fewer years. For example, a business owner receiving the maximum $30,000 a year with five years to retirement hypothetically would receive less at retirement than a 30-year-old employee receiving $5,000 a year would receive at retirement, assuming the plan continued after the business owner's retirement.

Age-weighting allows employers to skew benefits in favor of older employees, but it does not always produce the desired results. For example, with an age-weighted plan, a 60-year-old clerical worker may receive a greater benefit than the employer would like to provide, while a 30-year-old company owner may receive a smaller benefit than desired. Age-weighting also creates potential problems for partnerships. Consider, for example, a two-person partnership where the partners are 35 and 50. Age-weighting would give the older partner an annual contribution more than twice as large as that of his partner.

New comparability addresses these issues. Because new comparability plans, like age-weighted plans, are based on aggregate projected benefits, it is still important that groups of highly-compensated individuals, as a whole, be older than groups of non-highly-compensated individuals if the plan is to work to the employer's advantage. However, when using new comparability, the age of one employee is less likely to throw off testing results.

New comparability regulations can be applied to all types of retirement plans, but in most cases they are likely to be used with profit sharing plans. Employers who are looking for flexibility will find that a new comparability plan is most flexible when it is set up as a profit sharing plan, since profit sharing plans allow employers to reduce or even eliminate contributions during years when the company has little or no profits.

What Is New Comparability?

Regulations covering Section 401(a)(4) allow the creation of not only age-weighted profit sharing plans, but also new comparability plans. Although the regulations have existed since September 1991, most employee benefits experts either do not know about new comparability or are cautious about using it. However, the use of new comparability should increase significantly following a recent IRS interpretation confirming that new comparability is allowable under the regulations as they currently exist.

So exactly what is new comparability? New comparability gets its name because it gives employers a new way to compare groups of employees for nondiscrimination testing. But it is based on a concept that isn't so new. It relies on cross-testing, which was developed in 1981.[1] Typically, the participants in the plan are divided into classes, and then a separate contribution is made for each class. Within a class, the contribution is allocated uniformly (either as a flat dollar amount or as a percentage of pay). The classes may be based on any reasonable criteria (percentage of ownership, status as key or highly-compensated employees, job description, length of service, etc.). Cross-testing is then used to demonstrate that the resultant allocation complies with nondiscrimination rules.[2] As with age-weighted plans, the allocation for each participant is projected to retirement age and converted to an EBAR.

With new comparability, Section 410(b) nondiscrimination testing is satisfied by dividing employees into

"New Comparability": Increased Flexibility for Profit Sharing Plans?

"rate groups." Each highly-compensated employee, as defined by Code Section 414(q), determines a separate rate group. The group consists of that employee, and all others with an EBAR equal to or greater than his or hers. If each rate group satisfies 410(b) requirements, the allocation as a whole passes the Section 401(a)(4) test.

A new comparability plan provides the employer with more control than any other plan. The employer can design a new comparability plan that chooses precisely which employees will be rewarded and how much they will receive, based on how he or she sets up the rate groups. For example, one small business owner was able to contribute $30,000 a year to his plan while limiting contributions for his six employees to just three percent of pay.

Consider a company that has highly-compensated employees with EBARs of 12.62 and 4.83, and non-highly-compensated employees with EBARs of 12.62, 2.06, 4.83 and 5.16. Group I would consist of the two employees with EBARs of 12.62. Group II would consist of the highly-compensated employee with an EBAR of 4.83 and the non-highly-compensated employees with EBARs of 4.83 and 5.16, in addition to both employees in Group I, since both employees in Group I have EBARs exceeding 4.83.

Each rate group must then pass 410(b) testing, using either the ratio percentage test or the two prongs of the average benefits test. For this example, the plan passes the average benefits test, but not the ratio percentage test. Using the ratio percentage test, the proportion of non-highly-compensated employees is divided by the proportion of highly-compensated employees in each group. Since Group I contains one of four non-highly-compensated employees and one of two highly-compensated employees, the ratio percentage is 1/4 divided by 1/2, or 50 percent. Since the ratio percentage must be at least 70 percent to pass the test, Group I does not pass the test.

Now let's try the average benefit test. To pass the first prong, nondiscriminatory classification, the ratio percentage for each rate group must be at least equal to the midpoint between the safe and unsafe harbors from the table included in the 410(b) regulations (see Figure 1), based on the plan's concentration percentage. The concentration percentage is obtained simply by dividing the number of non-highly-compensated employees, by the total number of employees. Employees excludable under 410(b), such as those failing to meet age and service requirements, or non-resident aliens or union employees, are not included in this (or any other) calculation.

Since the sample plan has a concentration percentage of 66.6 (4/6), a ratio percentage of 39.75 is needed.

Figure 1
Reg. 410(b)-4(c)(4)(iv)

Non-highly-Compensated Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Non-highly-Compensated Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

In some cases, traditional plans do not allow the employer enough of a financial advantage to make it worthwhile to establish a profit sharing plan.

based on the table included with 410(b) regulations. The first rate group has a ratio percentage of 50. Since 50 exceeds 39.75, Group I passes the test. The second group has three of the four non-highly-compensated employees and both of the highly-compensated employees, so it has a ratio percentage of (3/4)/(2/2), or 75 percent. Because 75 exceeds 39.75, it also satisfies the requirements. Since all rate groups pass, the nondiscriminatory classification test has been passed.

To pass the second prong, an average benefit rate must be calculated. It is calculated by computing the average EBAR for highly-compensated employees and the average EBAR for non-highly-compensated employees. To pass the test, the average benefit rate for non-highly-compensated employees must equal or exceed 70 percent of the average benefit rate for highly-compensated employees. In the example, the average EBAR for highly-compensated employees is (12.62 + 4.83)/2, or 8.73 percent. The average EBAR for non-highly-compensated employees is (12.62 + 2.06 + 4.83 + 5.16)/4, or 6.17 percent. Since 6.17/8.73 = 70.67 percent, the plan passes the test.

New Comparability Comparisons

The advantage of new comparability plans is best illustrated by comparing it with other plan designs. In the first example above, a business owner has five employees and wants to maximize his own contributions while minimizing contributions for other employees.

As Figure 2 shows, a new comparability plan allows the employer to maximize his contribution at $30,000, while contributing a total of just $2,792 for his five other employees. Expressed as a percentage, 91.5 percent of the total contribution remains with the employer. This allocation is arrived at by dividing the employees into two classes, owners and non-owners. A contribution of $30,000 for the owners class is declared, and a contribution of three percent of pay for the non-owners' class is declared. The results are as shown in Figure 2. An age-weighted plan provides the second most attractive alternative, with 85.5 percent of the total contribution remaining with the employer and 14.5 percent, or $5,092, going to other employees. With more traditional plans, contributions to employees increase significantly. With an integrated plan, employees receive $10,184, or 25.3 percent of the total. With a salary ratio plan, employees receive $13,962, or 31.8 percent of the total.

These figures are based on first-year contributions only. The advantages of new comparability are even more apparent when viewed over time. While contributions may not remain constant from year to year, for the sake of this example assume that they do, and that annual deposits earn six percent a year. When the employer retires in 11 years, he will have accumulated $506,098 for himself, compared with a total of $47,107 for other employees (Figure 3). Other employees would earn $85,897 using an age-weighted plan, $171,809 using an integrated plan, and $235,534 using a salary ratio plan. While the $188,000 difference between the new comparability plan and the salary ratio plan includes interest accumulated over 11 years, it is still clear that annual savings can be significant.

In some cases, traditional plans do not allow the employer enough of a financial advantage to make it worthwhile to establish a profit sharing plan. Consider, for example, a restaurateur with 30 employees who wants to contribute the maximum amount for herself and minimize contributions to other employees (see Figure 4). She retains only 27 percent of the total contribution under a salary ratio plan, with $29,772 for herself and $80,652 for other employees. Because she will not reach retirement for 22 years, even an age-weighted plan would not benefit her. To receive the $30,000 maximum, she would have to contribute $51,757, or 63.3 percent of total contributions, to other employees. Typically, employers will not set up a profit sharing plan unless

Figure 2

Comparison of Profit Sharing Plans

Employee	Age	Salary	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	54	$200,000	$30,000	$30,000	$30,000	$30,000
E1	20	10,500	1,575	1,149	315	315
E2	25	16,500	2,487	1,814	497	497
E3	38	15,000	2,250	1,641	610	450
E4	38	24,000	3,600	2,626	976	720
E5	49	27,000	4,050	2,954	2,693	810
Principal			30,000	30,000	30,000	30,000
Others			13,962	10,184	5,089	2,790

"New Comparability": Increased Flexibility for Profit Sharing Plans?

at least 70 percent of benefits go to preferred employees.

Using a new comparability plan, she is able to contribute $30,000 for herself and limit contributions to $17,254 for other employees. She retains 63.5 percent of the contribution, compared with just 27 percent using a traditional plan.

Again, a two-class approach was used — one class of owners, which received a $30,000 contribution, and one class of non-owners, which received a $17,254 contribution. Keep in mind that criteria other than ownership also could have been used to define the classes.

Advantages and Disadvantages

While these examples make the financial advantages of new comparability plans evident, other advantages also should be considered, including the following:

• Unlike age-weighted plans, which are most suited for small businesses, new comparability plans can be used effectively by medium-sized and even fairly large companies.

• They can be used with a 401(k) plan.

• They can be used to attract and retain employees with hard-to-find skills.

• If it is designed as a profit sharing plan, the employer retains the choice of whether to make a contribution in any given year.

As these advantages illustrate, new comparability is the ideal profit sharing plan for many businesses. However, it is not ideal for every business. Individual circumstances must be taken into account, and the following disadvantages should also be considered:

• Because they are tailored to small groups of employees within the company, they are sometimes more difficult and costly to develop than other plans, and may require more administration than many other defined contribution plans.

• New comparability plans must be monitored carefully and continually. Because they bring nondiscrimination testing to the limits, the departure of a single employee may push the company out of compliance.

• Though its impact is less significant than with age-weighted plans, demographic criteria still may determine whether a plan passes nondiscrimination testing. New comparability won't work for a 27-year-old running a company with six 40-year-olds. It will work for a 40-year-old running a company with six 27-year-olds.

Many business owners will find these disadvantages insignificant when compared with the advantages that new comparability offers.

Figure 3
Accumulations to Retirement

Employee	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	$506,087	$506,093	$506,093	$506,093
Others	235,534	171,809	85,897	47,107
Plan Total	741,621	677,902	591,995	553,205

Figure 4
First-Year Contributions

Employee	Salary Ratio Plan	Integrated Profit Sharing	Age-Weighted Profit Sharing	New Comparability
Principal	$29,772	$30,000	$30,000	$30,000
Others	80,652	59,514	51,757	17,254
Plan Total	110,425	89,514	81,757	47,254

Conclusion

As defined benefit plans have become subject to increasing regulation by the IRS, the U.S. Labor Department, and the Pension Benefit Guaranty Corporation (PBGC), new, more attractive defined contribution options have become available. This availability will further hasten both the reduction in the use of traditional defined benefit plans, and the increased use of defined contribution plans, even by small businesses. Efforts by the Clinton Administration to restrict benefits to high-income individuals, including business owners, will make new comparability and other plans that skew benefits in favor of employers, even more attractive.

A word of warning. As this article was being prepared, the PBGC had legislation filed that would disallow cross-testing, which is the basis for designing new comparability plans. The fate of this legislation is unknown, but practitioners should monitor new developments carefully. Even if the legislation eventually is signed into law, Congress could take several years to act on it. Employers

may want to consider adopting a new comparability plan while it is still permitted, then amending to the next most favorable type of plan if and when Congress takes action. ■
(I/R Code No. 5900.00/6400.08)

Edward F. Londergan is a consultant of tax-qualified plans for Allmerica Financial. A 1980 graduate of Holy Cross College, Mr. Londergan joined Allmerica Financial in 1983 as an agent for the company's Worcester insurance agency. He joined Allmerica Financial's home office in 1985 as administrator, employer retirement plans, and was promoted to consultant in 1988.

Paul Vickers, ChFC, FLMI, is a consultant of tax-qualified plans for Allmerica Financial. A 1968 graduate of Princeton University, Mr. Vickers earned a master's degree in mathematics from the University of Pennsylvania in 1970. He joined Allmerica Financial in 1974, and has served since then in the systems development division and individual retirement planning area. He received the Fellow, Life Management Institute designation in 1981 and recently earned the designation of Chartered Financial Consultant (ChFC).

(1) Rev. Rul. 81-202, 1981-2 CB 93.
(2) IRC §1.401(a)(4) - 8(b)(2).

THE WALL STREET JOURNAL MONDAY, AUGUST 16

Small Firms Turn Retirement Plans Into Owners' Ga

YOUR MONEY MATTERS

By Ellen E. Schultz
Staff Reporter of The Wall Street Journal

Is it a retirement plan, or a tax shelter?

At a growing number of small companies, it can be hard to tell the difference.

More and more small business owners – including doctors, dentists, accountants and lawyers – are discovering lush loopholes that let them turn retirement plans intended for all employees into tax shelters that benefit mostly the owner or a handful of highly paid people at the top.

The new devices, called "age-weighted" and "cross-tested" plans, enable owners to keep as much as 95% of the annual contributions to the plan, to exclude lower-paid employees, and to reduce the total annual contributions they make to the plan on behalf of rank-and-file workers.

Employers can do this by blending rules used in retirement savings plans with rules used in pension plans. When the resulting formula is combined with regulations meant to prevent retirement plans from discriminating in favor of the highly paid, the result is a legal way to discriminate in favor of the top-paid. How much an owner can actually keep depends on how much goes into the plan, the number of employees, their age and salaries.

"They're tax-planning devices," is how David Wray, president of the Profit Sharing Council of America in Chicago, characterizes them. "Basically, they're put in because one person want to defer as much salary as possible," he adds.

Further, the new tax law will cause these plans to spread like brush fire, pension experts predict. "Before the tax law changed, it was a good deal. Now it's a better deal" for owners, says Marcy Supovitz, vice president of retirement plans for Pioneer Mutual Funds in Boston.

The plans make it possible for employers to escape restrictions in the new tax law on contributions to top-paid employees. The new law effectively limits the annual contribution an employer can make for a person in a traditional profit-sharing plan or SEP (simplified employee plan) to no more than $22,500 – 15% of the total "eligible" compensation of $150,000. But with these new types of plans, the amount that can be distributed to an individual remains 25% of pay, up to $30,000.

Already, these new mutant species of retirement plans are growing like kudzu vines, and strangling milder, existing competitors, such as traditional profit sharing plans 401(k) plans and SEPs. Over [illegible] thousands of employers

Keeping a Bigger Piece of the Pie

Business owners can replace existing retirement plans with ones that provide them with greater percentage of the money contributed. As this illustration for a five-person plan shows, the owner gets 52% of the total contributions to a traditional profit sharing plan which all employees received 15% of their pay. But under "age-weighted" and "compara ty" plans, the owner can keep as much as 85%. Comparability plans also let the owner lower the amount contributed for rank-and-file workers; in this example, saving $8,026.

EMPLOYEES		CONTRIBUTIONS TO PROFIT-SHARING PLAN		
AGE	INCOME	TRADITIONAL (15% OF PAY)	AGE-WEIGHTED	CROSS TESTED
55	$235,840	$22,500	$28,784	$30.00
55	50,000	7 500	9 595	1 95
45	40,000	6,000	3,395	1 56
35	30,000	4 000	1 126	1 17
25	20,000	3,000	600	78
TOTAL CONTRIBUTIONS		$43,000*	$43,000*	$35,4

*The total amount that can be contributed to plan, by law; this is 15% of the total eligible compensation of $290,000. (Under the new tax law, only $150,000 of an employee's pay can be used when calculating contributions to a plan.)

Source: National Life of Vermont

have converted their retirement plans to age-weighted and cross-tested profit-sharing plans.

The plans have been given their biggest push by life insurance companies, which administer them for a fee, and sell investments to the plans they oversee. At National Life of Vermont, age-weighted plans comprise 25% of all profit-sharing plans they administer; at Berkshire Life Insurance Co., age-weighted plans account for most of its new retirement plan business.

Some mutual fund companies that have retirement-plan divisions are also moving quickly into this market, including Oppenheimer & Co., Dreyfus Service Corp. and Pioneer Mutual Funds.

There's a lot of room for growth: According to the Department of Labor, 88% of businesses in the U.S. today employ 20 or fewer employees, and those businesses are typically owned by people who are older and better paid than their employees.

Critics say that the new plans pervert the social policy goals of retirement plans, which are given tax breaks because they are intended to help lower- and middle-income Americans put money aside for retirement.

Further, some people note that the plans give employers an incentive to discriminate against older workers. "It makes hiring an older person more expensive," says Harry Conaway, a principal at the Washington office of William M. Mercer Inc., a benefits-consulting concern.

But many pension experts say t plans fill a need for employers. "Th people who have poured their profi in their businesses, and don't ha many years until retirement," sa Supovitz. "Younger employees rather have more take-home pay, than retirement savings."

Age-weighted plans were mad ble by an Internal Revenue Service 401(a)4, that went into effect tw ago.

Essentially, it said that retirem ings plans offered by employers c formulas similar to those pension p when determining how much m allocate for employees. Pension f give older workers the lion's shar contributions an employer mak plan. The reasoning is that the fewer years until retirement, so given to them is worth less than given to a younger person.

About a year ago, the pensi munity realized it could also use cr ing rules to provide even more ad to top-paid employees. Cross-tes mulas were designed to prevent re plans from discriminating in fav older, higher-paid workers. The ru cally require the administrator t employees into highly paid and lo groups, and make sure that the paid group doesn't get a sig higher percentage

When these provisions are c

THE WALL STREET JOURNAL MONDAY, AUGUST 16, 1993

Smaller Firms' Retirement Plans Are Turned Into Owners' Bonanza

Continued From Page C1

with age-weighting formulas, the owner can keep most of the money. "From a theoretical perspective, the plans are nondiscriminatory," says Mr. Conaway. "If you convert the dollar amount [that lower-paid people get] to age-65 dollars, the benefit is the same percentage of pay."

But as helpful as the new plans may be for small-business owners, they have serious drawbacks for rank-and-file workers. To begin with, the plans can exclude altogether some lower-paid employees, as long as 70% of the lower-paid employees are eligible to participate in the plan.

Even those who participate may never see a dime of retirement money, however, because these plans have vesting schedules lasting as long as six years. Since younger, lower-paid employees typically have high turnover, many aren't likely to qualify to receive their profit-sharing money. Forfeited contribution are reallocated to the remaining people in the plans, on an annual basis.

"The bottom line is, a large portion of those contributions never go to those employees at all, because of the forfeitures," say Ms. Supovitz.

JUNE 1993

SKEWED RETIREMENT PLANS HELP OWNERS AT WORKERS' EXPENSE

The new comparability plans take a me-first approach to retirement.

By Donald Jay Korn

For the past several years, traditional defined benefit plans have been on the wane. A survey by the accounting firm Grant Thornton found that 22% of small and mid-sized companies have terminated such plans. "Employers who offer defined benefit plans are subject to numerous administrative requirements and increasing regulations imposed by the IRS, the Labor Dept., and the Pension Benefit Guarantee Corp.," says Andrew Zuckerman, Grant Thornton's director of employee benefits.

For closely held businesses, the bottom line is often increasing expense, for overhead and employee contributions, while contributions to owners' personal accounts are limited. President Clinton's tax proposal, if adopted, would further restrict benefits to high-income executives, including the owners of small companies. "Many employers will see their personal retirement benefits reduced and will be less willing to provide plans for their employees," Zuckerman says.

Ironically, while a substantial amount of squeeze-the-rich activity has been coming out of Washington, the IRS has just proposed regulations under Code Section 401(a)(4) that would permit skewing of benefits in retirement plans. In certain circumstances, so-called "new comparability" plans allow close to 90% of corporate contributions to be made of behalf of owner-executives. "Business owners ask us if these plans are for real," says David McKeon, second vice president in charge of retirement plan marketing at The New England. "We're seeing the return of the defined benefit client who's been largely absent since 1987."

These new comparability rules apply to all types of plans but the greatest impact likely will be on profit-sharing plans, which are gaining popularity because of their flexibility. In a bad year, companies can reduce or even eliminate contributions to profit-sharing plans. (By contrast, defined benefit plans lock employers into contributions, come what may.) Judging by the proposed regulations and statements by IRS officials, financial planners can advise their business owner clients to look into new comparability profit-sharing plans.

A basic profit-sharing plan offers simplicity as well as flexibility. A plan might, for example, call for contributions equal to 15% of each participating employee's compensation. An employee earning $100,000 would get a $15,000 contribution, one earning $20,000 would get a $3,000 contribution, and so on.

Such plans may be flexible and simple, but they often don't meet the desires of business owners. McKeon gives the example of a company with two owner-executives, each earning $150,000, and eight other employees, earning a total of $300,000 *(see chart above)*. "The contributions on behalf of the owners would be only half the company's total contribution," McKeon says.

Such problems can be addressed with age-weighted profit-sharing plans, which won IRS approval a couple of years ago and have been gaining ground ever since. In these plans, it's not the annual contribution that has to be equivalent, from one employee to the next; instead, the expected future benefit for each employee must be equivalent, as a percentage of compensation.

Suppose two employees, age 50 and 30, both earn $30,000. In a vanilla profit-sharing plan, each might get a 15% ($4,500) contribution. But that $4,500 will provide a much greater benefit to the 30-year-old employee, when he retires at age 65, than it will to the 50-year-old, when he retires at 65. That's because the 30-year-old

will enjoy 20 more years of tax-deferred buildup.

An age-weighted profit-sharing plan takes those differences into account. The older the employee, the greater the current contribution, because there are fewer years left to retirement. More of a nest egg must be accumulated in a shorter time period. Such plans may be favored by closely held businesses because the owners tend to be older than most of their employees. In the example given by McKeon, the owners' share of the contributions rises from 50% of the total to [illegible]%.

But age-weighted profit-sharing plans have their drawbacks, too. If there are two principal owners, the older one gets a larger share of the pie than the younger one. As you can see in Table 1, the older owner gets a $30,000 contribution (maximum for profit-sharing plans) while the younger owner gets only $22,500.

Also, age-weighted plans may give surprisingly large contributions to other older employees. In this example, a 60-year-old clerk earning $25,000 a year gets a $6,250 contribution. Many business owners don't like the idea of directing such a large contribution to a non-essential employee.

New comparability plans address such concerns. Again, these are age-weighted plans. Plan participants are divided into groups. Within each group, contributions are the same percentage of compensation. However, the percentage for the older group (presumably the owners) can be much larger than the percentage for the younger group. These plans are designed so the aggregate projected benefits are equivalent, from one group to the next.

In McKeon's illustration, the two owners each get contributions of $30,000, 20% of compensation. Each of the other eight employees, in a group where the average age is 37, gets only 3% of salary. The 60-year-old clerk gets a $750 contribution, not $6,250.

> **"For a lot of owners, their real retirement plan is their business."**

Compared with a plain vanilla profit-sharing plan, total contributions are reduced by more than $20,000, from $90,000 to less than $70,000, while the owners each get a $30,000 contribution, not $22,500. Altogether, 87% of the contributions now go to the two owners. "As long as the average age of the owners is at least five years greater than the average age of the other employees, new comparability plans probably will do the most for owners," McKeon says. "That's been the case in every illustration we've looked at so far."

Will the IRS really approve a profit-sharing plan in which the business owners get 20% contributions and the other employees only 3%? Yes, if certain tests for non-discrimination show that the projected benefits for the rank-and-file are at least 70% of the projected benefits for the highly paid. However, these tests are complex so the services of an actuary or a pension consultant will be needed each year, to insure compliance. "A small company might spend a couple of thousand dollars each year, to implement such a plan," says McKeon. "As you can tell by the example, that may be modest compared with the potential benefits."

McKeon points to other advantages of these plans. "They're extremely flexible," he says. "You can re-set the groups each year, if you wish. Instead of two groups, you might have three groups—owners, key executives, and other employees—giving something extra to key people. Although the IRS hasn't stated this, we think a group can contain just one person. We compare new comparability plans to non-qualified plans, because owners can select employees to get the most benefits, yet contributions are tax-deductible because they're qualified plans."

"There's no question that new comparability plans can deliver more to business owners than a standard profit-sharing plan," Zuckerman says, "and they may well deliver more than an age-weighted plan. Nevertheless, they may not be right for every company."

New comparability plans, like all profit-sharing plans, have a $30,000 annual cap on contributions. Some business owners—older ones with much younger employees—may make considerably larger contributions to their own accounts with defined benefit plans, in the right circumstances. If clients are going to have to pay for an actuary each year, to handle retirement plan calculations, and they're confident the business will generate ample cash flow, they might be better off with a defined benefit plan.

On the other hand, skewing a retirement plan might hurt employee morale and reduce performance. "For a lot of owners," Zuckerman says, "their real retirement plan is their business. Either they'll sell the company or live on dividends. Why jeopardize the success of this business by antagonizing employees? In the end, each business owner has to come up with the choice he or she prefers."

Similarly, financial planners can only advise their business owner clients, not make the ultimate decisions. In order to give the best advice, planners need to know all the options. They need to familiarize themselves with comparability plans, the latest star in the retirement planning firmament, because they may shine brightest on the business owner client who's truly out for himself and isn't concerned with employee retention. FP

PREPARED STATEMENT OF MARTIN SLATE

I am honored to join Secretary Reich and Assistant Secretary Samuels to discuss the Administration's Retirement Protection Act. This is comprehensive, balanced legislation. It will squarely address underfunding in our nation's pension plans and protect the benefits of American workers and retirees. I join the Secretary and Mr. Samuels in underscoring that this is indeed the time for reform.

I. INTRODUCTION

Our reforms may be summed up in one word: funding. We believe that the present pace and certainty of pension plan funding are inadequate. Steps should be taken to assure that sponsors of underfunded plans significantly accelerate their pension contributions.

Our major reform measures will:
- strengthen the funding rules for underfunded plans;
- enhance PBGC compliance authority;
- increase premiums for those plans that pose the greatest risk; and
- broaden participant disclosure requirements.

Fully funded plans will not be affected by our major reforms.

I thought I could be of most help to the Committee this morning if I detailed the growing long-term problem in pension underfunding and then provided further explanation of our reforms . . . how they work and why they will work.

II. THE PROBLEM

Most pension plans are fully funded. Pension underfunding in certain industries, however, is a chronic problem, growing and persistent. In the last six years, underfunding has nearly doubled—from $27 billion in 1987, to $38 billion in 1991, and to $53billion in 1992. While some of the most recent underfunding is attributable to the drop in interest rates, it is clear that the current funding rules are not working. Even if interest rates had not fallen, underfunding would still have increased. Certain companies simply are not putting enough money into their pension plans.

About three-quarters of this underfunding is in plans sponsored by financially healthy firms and does not present an immediate risk to participants or the PBGC. The most severe risk lies with the remaining plans, with an estimated $14 billion in underfunding, accounting for approximately 1.2 million workers and retirees. These plans are maintained by companies with below investment grade bond ratings.

Like Secretary Reich, I have been encouraged by promises of increased funding by certain companies. Even with these contributions, and even with the recent rise in interest rates, serious and substantial underfunding will persist without strong legal reform.

For participants, this underfunding threatens the loss of benefits not covered by the PBGC guarantee.

These underfunded plans also pose a risk to the PBGC. The PBGC is in no immediate danger. This is because we pay benefits out over time, just as pension plans do. However, until chronic underfunding is addressed, the long-term health of the PBGC remains in jeopardy. Our deficit now approaches $2.9 billion. In the last few weeks, the General Accounting Office (GAO) validated this deficit. GAO expressed concern about PBGC's financial future because of the disturbing trends in the PBGC deficit and pension underfunding.

These trends must be reversed.

III. APPROACH TO REFORM

The Retirement Protection Act is carefully drafted to reduce underfunding markedly, but in a reasonable, doable way. In preparing this legislation, we set a number of guideposts.

First, we set a goal of funding all vested benefits in 15 years. This will assure that benefits for workers in the industries most affected by underfunding will be paid.

Second, we sought to fix only what is broken. Our reform proposals target underfunded plans. Fully funded plans—most plans—are not affected by our major reforms.

For those who are affected, we sought to make the reforms affordable. Our reforms are based on actual experience under current law and modelling of data from real plans. These reforms will protect the pension benefits of American workers and retirees, while at the same time allowing business to continue. The underfunding

gap must be closed, but business and work must move forward. We think the porridge is just about right. The reforms are reasonable.

Finally, we sought to build on current law. We were able to identify the structural problems in the law and to address those problems in a way that will assure that the promise of ERISA is kept for all.

IV. THE LEGISLATION—STRENGTHEN THE FUNDING RULES FOR UNDERFUNDED PLANS

Our primary reform is to strengthen the funding requirements for underfunded plans.

ERISA Rules

In 1974, ERISA established the concept that a plan must be funded in advance—money must be put aside currently for benefit payments that are due in the future. The ERISA funding rules provided a good start for sound funding, but many plans remain severely underfunded. In part, acute underfunding persists because companies were permitted to fund a portion of their benefit liabilities over a period of 30 to 40 years.

OBRA '87

Thirteen years after ERISA, Congress addressed funding again. OBRA '87 introduced the deficit reduction contribution (DRC), an additional minimum contribution requirement intended to accelerate funding in underfunded plans.

Despite the DRC, plan funding has not unproved since 1987. Companies can utilize credits and offsets and set actuarial assumptions so that contributions are minimized. Fully within the law, many employers have been able to make little or no pension contributions, even though their plans are severely underfunded.

Between 1989 and 1992, for example, after paying for current year accruals, contributions to half of the underfunded plans of companies with the largest underfunding did not even cover the interest on their unfunded liabilities. This is comparable to paying off only part of the interest on a credit card and none of the principal.

Reform Proposals

To get the DRC back on track, our, reforms make three changes.

(1) Strengthen the DRC Formula.

First, to speed up pension funding, we would change the DRC formula so that in severely underfunded plans, most new liabilities would be paid for within five to seven years.

(2) End Double Counting.

Second, we end the double counting of gains (and changes in liabilities due to changes in actuarial assumptions) under the DRC and the plan's funding standard account. This double counting of credits has enabled employers to . . contributions. A plan sponsor would be required to pay the larger of the DRC or the regular minimum funding requirement.

(3) Constrain Assumptions.

Finally, our reforms require the use of specified interest rate and mortality assumptions to determine contributions. We propose to narrow the DRC corridor for interest rate assumptions to between 90% and 100% of the four-year weighted average of Treasury bonds and require use of the GAM '83 mortality table. This is the nationally accepted mortality table used by most states to calculate insurance company reserves for annuities. These assumptions are designed to measure the amount necessary to fully fund the plan on a termination basis. Only by requiring that employers use these assumptions will we be able to fully fund pension plans. A bill that does not include these requirements, particularly the mortality standards, will lose much of its force.

To moderate the impact of this change, plans could amortize any resulting increase in pre-1995 liability over 12 years.

Plan Solvency

In addition to these overall changes in the funding rules, our reforms include a special solvency rule to insure that severely underfunded plans would be able to meet their benefit obligations. To assure benefits are paid, a severely underfunded plan would be required to maintain cash and marketable securities equal to approximately three years' worth of benefit payments.

Benefit Increases

The bill requires that benefit increases be funded on an accelerated schedule—in most cases, over five to seven years. It also requires that employers recognize immediately, for funding purposes, any benefit increases that have been bargained but

are not yet in effect. (Under current law, an employer is not required to start funding these benefit increases until they are effective.)

It is our view that benefit increases should be paid for speedily through strengthened funding requirements. Explicit restrictions on benefit increases are not necessary and are unfair to working people and to retirees.

Effective Dates

Our proposals will be effective for plan years beginning in 1995. These new rules will pick up increases that were negotiated in 1992 and 1993.

Transition Rule

Accelerated funding is essential if plans are to be placed on a sound footing. At the same time companies need to be able to move forward with their business. The legislation contains a special transition rule to protect employers from extraordinary increases in their annual contributions for up to seven years. Although the rule varies according to the plan's funding ratio, it generally limits the required annual increase in employer contributions to the amount necessary to achieve a three percentage point per year increase in the plan's funding ratio.

Exceptions

Most of our rules would not affect plans with 100 or fewer workers.

Remove Impediments to Funding

Most of our funding reforms strengthen the minimum funding requirements. We also want to remove certain impediments that discourage employers from fully funding their plans. For example, we propose to eliminate the excise tax that inhibits companies with both a defined benefit and a 401(k) plan from contributing when the combined funding would exceed 25% of compensation. We also propose to eliminate the quarterly contribution requirement for well-funded plans.

ENHANCE PBGC COMPLIANCE AUTHORITY

Strengthened funding rules should assure improvements in most cases. There are, however, special circumstances where enhanced PBGC compliance authority is also needed to provide better pension protection.

All too often we have seen companies undertaking business transactions that endanger pension promises. For instance, a healthy corporation might spin off a subsidiary in poor health with an underfunded pension plan. This can leave the subsidiary's plan without a source of funding because the corporate tie is broken.

The only remedy PBGC has in these circumstances is to terminate the plan. This can be a harsh remedy because participants are hurt, and the resulting claim for plan underfunding can have serious consequences for employers.

Our proposals would allow PBGC to apply to the federal court for remedies other than plan termination. For example, PBGC could seek to impose funding responsibility, for a certain period of time, on a corporation that sells a subsidiary.

Our reforms are tailored. They would apply only when the transaction is of a substantial nature, involving more than 10% of a controlled group's assets, revenues, or operating income and only when a transaction poses a risk to the PBGC. Our desire is to protect benefits, not to hobble corporate transactions.

We also propose to require companies whose plans are underfunded by more than $50 million to provide PBGC with advance notice of transactions that might affect underfunding. Much of this is like the Hart-Scott-Rodino notice procedure used by the Federal Trade Commission in the antitrust area, but it will affect far fewer transactions. Had this notice provision been in effect in 1993, 30 transactions would have been covered.

BANKRUPTCY

We continue to support bankruptcy reforms that would: (1) make it clear that companies are required to make their minimum funding contributions before they come out of bankruptcy; and (2) give the PBGC the option of being a member of creditors' committees.

INCREASE PREMIUMS FOR THOSE PLANS THAT POSE THE GREATEST RISK

We propose to increase premiums for plans that pose the greatest risk by phasing out the current cap on PBGC's variable rate premium over three years.

PBGC's annual insurance premium for single-employer plans has two elements—a flat-rate of $19 per participant paid by all plans, and a variable rate charge for underfunded plans. The variable rate charge is capped at $53 per participant. This cap weakens the funding incentive for the most seriously underfunded plans.

While plans at the cap account for 80% of all the underfunding in single-employer plans, their premiums represent only about 25% of PBGC's total premium revenue. We need to put the responsibility where it belongs and change the incentives in the premium structure. As their plans become better funded, employers will pay less in premiums over time.

BROADEN PARTICIPANT DISCLOSURE REQUIREMENTS

Our reforms would require that timely, clear information on plan funding and PBGC guarantees be provided to participants in underfunded plans. The more people know about their pensions, the better.

Also, our bill seeks to facilitate payment of benefits to so-called "missing participants." The PBGC has an active program for locating participants in terminated underfunded plans that we trustee. Our legislation would build on this effort by establishing the PBGC as a central clearinghouse for employers terminating fully funded plans who have difficulty providing benefits to missing participants.

OTHER CHANGES

We propose a number of other changes. These include:

- elimination of "cross-testing" of profit-sharing plans;
- more flexible remedies for the PBGC to address noncompliance in standard termination procedures;
- revision of the interest rate and mortality assumptions that a plan may use to calculate a lump-sum distribution; and
- the rounding down of the annual increases in the contribution and benefit limitations for retirement plans.

V. CONCLUSION

These reforms will markedly increase funding in the most underfunded plans and do so in a reasonable, affordable way. Again, all vested benefits will be funded within fifteen years. We project, based on prior PBGC experience, that the PBGC deficit will be eliminated within ten years.

The reforms are targeted in very specific ways to correct current law and make it work. At the same time, the reforms are comprehensive and balanced. We think we have the fix for the problem, and we think it's the right fix.

The pension system is fundamentally sound, but the problems that are developing today can become the red flags of tomorrow. It is important to address these problems now, while they are still manageable. If we wait, the medicine will most certainly have to be stronger.

We must stay ahead of the curve and take every step possible to assure that the hard-earned benefits of our nation's workers are protected.

PENSION BENEFIT GUARANTY CORPORATION,
Washington, DC, June 30, 1994.

Hon. DANIEL P. MOYNIHAN,
Chairman, Committee on Finance,
U.S. Senate,
Washington, DC

Re: *Retirement Protection Act of 1993. S. 1780*

Dear Mr. Chairman: On behalf of Secretary Reich and the other members of the Pension Benefit Guaranty Corporation's Board of Directors, I would like to thank the Finance Committee for its timely and important hearing on S. 1780, the "Retirement Protection Act of 1993." At the hearing, you requested that the PBGC offer its perspective on statements made by other witnesses. I appreciate the opportunity to do so.

* * *

Let me underscore the need for the legislation before addressing the specific statements. Underfunding is entrenched and will not simply go away on its own. The Interagency Task Force that Secretary Reich appointed last year to review pension funding met with 77 people with major stakes in the retirement plan system—representatives of business, labor, retiree groups, and pension experts. Virtually all agreed that pension underfunding presents a serious long-term problem that should be addressed by legislation now.

The Retirement Protection Act is carefully crafted to speed up funding of chronically underfunded plans in a balanced and affordable way. The heart of the Administration's proposal is to strengthen the funding reforms started by OBRA '87 now while the problem is manageable. Our proposals are the product of detailed analyses of experience under current law and projections of future impact using models based on actual corporate financial and pension plan data.

At the hearing, witnesses raised issues with respect to the seriousness of the problem and the effect of various provisions of the bill. I offer the following facts and clarifications in response to the questions raised.

PBGC'S DEFICIT IS REAL

While certain witnesses questioned PBGC's deficit figures, the General Accounting Office recently validated the deficit in its audit of the agency's finances. The PBGC's deficit in the single-employer program is $2.9 billion.

The PBGC uses Generally Accepted Accounting Principles, as do the corporations sponsoring the pension plans we regulate. These principles require the PBGC to include losses from "probable" claims in its financial statements.

Our deficit is projected to grow if reforms are not enacted. This projection is based on our claims experience and economic assumptions generally used by the Office of Management and Budget and the Congressional Budget Office.

PENSION PLAN UNDERFUNDING IS CHRONIC AND PERSISTENT

The seriousness of underfunding is demonstrated by the fact that underfunding has nearly doubled in the last six years—from $27 billion in 1987, to $38 billion in 1991, and to $53 billion in 1992. Some of the most recent underfunding is attributable to the decline in interest rates, but underfunding is nevertheless chronic and persistent. Our analysis shows that even if interest rates were held constant, underfunding in half of the 50 companies with the largest underfunded pension plans, which we publish annually, would have gotten worse from 1991 to 1992.

Interest rates are cyclical. Although they may go up over time, causing liabilities (and sometimes assets) to shrink, they just as certainly will decrease over time as well. Plans can terminate at any point in the cycle, so we cannot count on increasing interest rates to take care of the problem for us.

THE RETIREMENT PROTECTION ACT IS AFFORDABLE

The concerns about affordability expressed at the hearing are the same concerns that the Task Force heard and acted upon in tailoring the bill's reforms. We have conducted extensive analyses and tested the reforms on financial data from actual companies and plans to assure affordability.

We focus on the problem area—those plans that are underfunded. We have included a seven-year transition rule to mitigate the impact of large contribution increases and still accomplish our basic funding goals. There may be some companies affected by large increases when the transition period ends. These companies can reduce any impact of such increases by putting in more than the minimum contributions during the early years.

The issue here is really not affordability. Rather, it is to assure that companies do not have the opportunity to avoid paying for their pension promises. Under current law, even companies with the most underfunded plans have the flexibility to minimize or eliminate their pension contributions. Now, with the economy on the upswing, is a perfect opportunity for companies to commit to putting money into their pension plans.

THE FUNDING REFORMS WILL ASSURE ADEQUATE FUNDING

The bill sets a goal of funding all vested benefits in 15 years. While some witnesses said that this goal is too high, the Retirement Protection Act's objective is to get companies with underfunded plans to fund in a manner that more closely reflects the real-world risk to participants and actual exposure to the PBGC if the plan should terminate. As Senator Bradley noted during the hearing, a recent study by the General Accounting Office on hidden liabilities, such as early retirement subsidies, confirmed how quickly plan liabilities increase in a terminating plan.[1]

---

[1] In "Hidden Liabilities Increase Claims Against Government Insurance Program" (GAO/HRD-93-7), December 30, 1992, GAO surveyed 44 plans with the largest claims against the PBGC for calendar years 1986-1988 with unfunded liabilities of $1 million or more at termination. All but two of these plans had hidden liabilities. GAO characterized unfunded liabilities not reported by the plans prior to termination, such as early retirement benefits, as hidden li-

FIXING ASSUMPTIONS WILL IMPROVE FUNDING

Constraining assumptions for interest and mortality goes to the heart of the legislation's goal of assuring funding of vested benefits in 15 years. Even a small change in interest rates or mortality assumptions can significantly reduce a company's required funding.

While some argued for setting their own actuarial assumptions, experience has shown that companies will use the latitude that they have in current law to minimize contributions. If companies are permitted to continue to use their own mortality assumptions, our bill's ability to achieve real improvement in underfunding will be significantly curtailed. Less than half of the improvement we anticipate from the reforms would be realized.

The current flexibility that employers have to set actuarial assumptions is problematic. Take the case of the two car companies that I referred to during my testimony. One company uses a mortality table that has its workers dying twice as fast as the other company's mortality table, even though the demographics of the two workforces are similar. The Retirement Protection Act would end such major disparities. The Act requires plans to use the mortality table, GAM 83, that insurance companies are required to use by the IRS and the states.[2]

The legislation also sets a range of interest rates that plans can use to calculate contributions. Setting the interest rate corridor at 90%–100% of weighted 30-year Treasury rates brings the funding target more in line with the value of termination liability. The Act does not ask that companies with healthy plans use these assumptions; they are simply intended to begin the process of getting underfunded plans funded more quickly so that, if they terminate, the PBGC and participants are protected.[3]

UNCAPPING THE VARIABLE RATE PREMIUM BRINGS EQUITY AND FUNDING INCENTIVES TO THE PREMIUM STRUCTURE

PBGC's annual insurance premium for single-employer plans has two elements—a flat-rate of $19 per participant paid by all plans, and a variable rate charge for underfunded plans. The variable rate charge is $9 per $1,000 of underfunding, and is capped at $53 per participant. Thus, the maximum premium per participant for an underfunded plan is $72.

Underfunded plans are not now paying their fair share in premiums, despite the increased risk they impose on the system. Nor does the cap provide any incentive to increase funding. Plans accounting for 80 percent of the underfunding pay only 25 percent of the variable rate premium. While some witnesses said that no premium increase is warranted, removing the cap provides for fairness, puts the responsibility where it belongs, and rewards underfunded plans that do fund up.

The focus of this legislation is on funding. Increasing the variable rate premium will encourage better funding. We are only asking companies to pay less than a dollar for every $100 in underfunding. As their plans become better funded, employers will pay less in premiums over time.

PBGC NEEDS BETTER COMPLIANCE AUTHORITY TO PROTECT PENSIONS

PBGC needs enhanced compliance tools to better protect pension benefits, not to interfere in ordinary business affairs as some have suggested. All too often we have seen companies undertake business transactions that endanger pension promises. For instance, a healthy corporation might sell off a subsidiary in poor health with

---

abilities to the PBGC. These hidden liabilities increased the reported underfunding by nearly 60% by the time these 44 plans became PBGC claims ($1.7 billion to $2.7 billion).

[2] During the hearing, reference was made to a 1987 mortality study of the Society of Actuaries that was said to show that GAM 83 is more conservative than actual experience. It appears that the witness had focused on only part of the study involving only some workers. A more complete look at the study demonstrates the reasonableness of GAM 83. When the study's data on healthy active workers, as well as retirees, are considered, and applying even a modest mortality improvement from the date of the study to the proposed effective date of the legislation, the resulting liabilities for a typical plan, calculated using the rates in the study, are virtually the same as those calculated using GAM 83.

[3] One witness objected to the bill's interest rate assumption because it is more conservative than Financial Accounting Standards Board standards. FASB standards are designed to disclose the funding status of *ongoing* plans, not to measure the cost to close out a terminated plan. The Actuarial Standards Board has stated in the strongest terms that FASB standards are inappropriate in measuring plan termination liability and should not be relied on by participants. Indeed, the Board has directed that actuaries caution users of financial statements that the FASB standard is not plan termination liability, and that other calculations are needed to judge benefit security at plan termination. (See, "Actuarial Standard of Practice No. 2.")

an underfunded plan. This can leave the subsidiary's plan without a source of funding because the corporate tie has been broken. Our compliance measures will guard against companies circumventing their pension obligations.

The reforms are carefully tailored. In the case of an entity leaving the controlled group, the alternative remedy proposal applies only in the case of transactions involving 10 percent or more of the corporate assets, revenues, or operating income, and only if they pose a risk to PBGC.

The advance notice proposal, which allows us to identify potentially harmful transactions before they can permanently damage a plan, only affects controlled groups with more than $50 million of underfunding (about 105 groups currently). It would have applied to fewer than 30 transactions in the last fiscal year. Our proposal is modelled on the Hart-Scott-Rodino notice procedure used by the Federal Trade Commission in the antitrust area, but it will affect far fewer transactions.

Let me give you a few examples of actual cases in which these enhanced compliance tools would have helped:

- In 1986, Carl Icahn's corporate group purchased TWA. In 1992, with the TWA pension plans under funded by about $1 billion and TWA in bankruptcy, Mr. Icahn negotiated a reorganization plan that severed TWA from the Icahn controlled group, leaving PBGC and the plan participants at risk for the underfunding.

  PBGC's only tool was the threat that the agency would terminate the pension plans while the Icahn entities were still a part of the controlled group and responsible for the underfunding. A plan termination likely would have closed the airline, resulting in the loss of 30,000 jobs. In the end, a settlement was negotiated with Mr. Icahn, but more sensible tools would have provided better protection.
- In 1985 White Consolidated Industries, a large conglomerate, sold off Blaw Knox which had $65 million in underfunding. Blaw Knox was unable to meet the funding requirements of the plans. The situation deteriorated to the point where the plans terminated in the last few years, costing the PBGC over $100 million and certain retirees some of their benefits.

  Had the PBGC had the appropriate compliance tools, benefits could have been better protected.

In closing, Mr. Chairman, I want to emphasize once again that the Retirement Protection Act is comprehensive and balanced. It is carefully targeted to correcting only what is wrong in current law. This legislation is a reform package; it is not a major overhaul of our pension laws. We thank you again for reviewing the Administration's proposal, and we look forward to working with the Committee on passage of this much-needed legislation.

Sincerely,

MARTIN SLATE, *Executive Director.*

PREPARED STATEMENT OF ROBERT M. SPIRA

Mr. Chairman and Members of the Committee: My name is Robert M. Spira, I am Director of Government Relations and Senior Corporate Counsel for Leaseway Transportation Corp. I am pleased to submit this testimony on behalf of the Multiemployer Pension Plan Solvency Coalition ("Coalition"). The Coalition is composed of employers who contribute to multiemployer pension plans and of industry trade associations that represent employers who contribute to multiemployer pension plans. These associations include the American Trucking Associations, Inc., the Associated General Contractors of America, the National Constructors Association, the National Association of Waterfront Employers and the Food Marketing Institute. The Coalition's principal goal is the passage of legislation that will address the serious problems caused by underfunding in multiemployer pension plans.

The Retirement Protection Act of 1993 (S. 1780), the Administration's proposal to improve pension plan funding, does not include provisions addressing funding levels in multiemployer pension plans. According to Secretary of Labor Robert Reich, the Administration believes that multiemployer pension plans do not present a problem because underfunding has decreased since 1980. Therefore, legislation addressing multiemployer pension plan funding levels is not required.

We disagree with Secretary Reich. His position ignores the facts. There is a problem. The problem is getting worse. It will not go away by itself. The favorable funding trends reported by Secretary Reich in his testimony to the House Ways and Means Committee on April 19, 1994 occurred in the 1980's. They are a thing of the past. Since, 1990, underfunding in multiemployer plans has more than doubled. It is the recent increases in underfunding, and the dramatic declines in the number

of active employee participants in some multiemployer plans, that are the relevant trends that Congress needs to consider.

Our Coalition testified before the House Ways and Means Oversight Subcommittee in 1991 and in 1992 and before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service in 1992. As a result of our testimony and the testimony of others, Congressman J.J. Pickle in the House and Senators Jeffords, Durenberger and Kassebaum in the Senate introduced the Pension Funding Improvements Act of 1993 (H.R. 298/S. 105). Title II of the Pension Funding Improvements Act is intended to control underfunding in seriously underfunded single and multiemployer pension plans through restrictions on benefit increases. We are confident that, upon review of the following facts, the Committee will agree that these provisions are a necessary part of any comprehensive pension reform.

1. According to the Pension Benefit Guaranty Corporation ("PBGC"), from 1980 and until 1990, multiemployer plan underfunding decreased from $33 billion to $5 billion. However, *since then underfunding has more than doubled.* According to PBGC estimates, the rate of increase in underfunding in multiemployer plans between 1990 and 1992 may actually be greater than the rate of increase in underfunding in single employer plans over the same period of time. Although PBGC has tried to attribute the increase in underfunding to the drop in interest rates and investment returns, a 1992 PBGC report admits that the alarming rise in underfunding was caused by falling interest rates and benefit increases. Exhibit A sets forth the levels of underfunding in certain multiemployer plans.

2. The recent increases in underfunding are even more significant when viewed in the context of the decline in the number of employees in these plans for whom contributions are made. Deregulation in 1980 resulted in a dramatic realignment of the trucking industry. Non-union segments have grown while traditional union carriers have languished. Employment levels in union trucking operations have declined by 40% since 1978.

These changes in the trucking industry have had a negative impact on union-sponsored multiemployer plans. Many of the underfunded multiemployer plans have lost between 40% and 60% of their active employee participants since 1978. These declines are expected to continue. Each decline in the contribution base of an underfunded multiemployer plan has the effect of increasing the exposure of the union employers who remain. However, some plans have experienced both increases in underfunding and declines in the number of active employee participants. Exhibit B illustrates the decline in the number of active employee participants in many of the most seriously underfunded plans.

3. There are 9 million employees covered under 2,000 multiemployer plans as of 1992. Approximately 3 million of these employees are covered by plans that are currently underfunded. Many multiemployer plans are funded at less than 90%.

In 1990, PBGC reported that 89 percent of all multiemployer plans covering about 80 percent of all multiemployer plan participants were fully funded for vested benefits. By 1992, however, only 80 percent of all multiemployer plans (covering about 68 percent of all multiemployer plan participants) were fully funded for vested benefits. Therefore, the number of underfunded multiemployer plans is increasing.

4. PBGC has been advised of weaknesses in its multiemployer program. In September, 1993, the General Accounting Office reported to Congress that the PBGC has not adequately assessed its liability for future financial assistance to financially-troubled multiemployer pension plans. Although S. 1780 fails to address these weaknesses, PBGC has acknowledged that if only one large multiemployer plan becomes insolvent the surplus in its multiemployer insurance fund could be wiped out.

We have been informed by PBGC that it monitors the financial condition of its multiemployer program. PBGC's "watch list" of troubled plans will only be effective to the extent that a troubled plan experiences an orderly, visible and gradual decline in its financial condition. However, current economic and competitive conditions create a climate in some industries in which business failures could trigger uncollectible withdrawal liability claims at a pace far quicker than could be monitored effectively by the PBGC.

5. PBGC guarantees pension benefits well below the level retirees would expect to receive if they were to get all the benefits they were promised. The maximum PBGC guarantee is calculated at $ 16.25 times the employee's years of service. A pensioner with 30 years of service would be guaranteed only $487.50 a month or $5,850 a year as compared with the $2,500 a month or $30000 a year promised by some of the underfunded plans.

As we have demonstrated, multiemployer plan underfunding threatens the PBGC and the employees who are relying on plan benefits for their retirement income. However, the Committee should not lose sight of the impact of underfunding on the

employers contributing to multiemployer plans. Under the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), employers are liable to the plan for their pro rata share of unfunded vested benefit liabilities ("withdrawal liability").

The problems of employers that arise from multiemployer pension plan underfunding are real. My employer, Leaseway Transportation Corp., is a trucking company with operations throughout the United States. Revenues for 1993 were approximately $630 million. As a result of obligations under our union contracts, Leaseway contributes to more than 40 multiemployer plans. Leaseway's aggregate contingent withdrawal liabilities to these plans are estimated to be in excess of the company's $50 million net worth. Although Leaseway does not desire to withdraw from any of the plans in which we participate, events outside of the company's control, such as the cancellation of a major contract, could result in claims that exceed our ability to pay.

Other union trucking companies who are members of our Coalition, particularly the smaller, family-owned companies, are also threatened by their obligations to underfunded pension plans. These obligations make it difficult, if not impossible, for these individuals to reap the benefits of years of hard work and risk. Potential purchasers are not willing or able to assume contingent liabilities that far exceed the value of the business. In addition, a company's financial results are affected because its pension fund obligations negatively impact credit ratings and interest rates.

Supporters for the present system have often claimed that multiemployer pension plan underfunding should be controlled through the collective bargaining process. This suggestion loses sight of what is and is not settled through collective bargaining. Wages and fringe benefit costs, including contributions to the pension fund, are negotiated through collective bargaining. Benefit levels are established by fund trustees.

The needed financial controls are not available to contributing employers through management of the funds. Although multiemployer funds have boards of trustees appointed in equal numbers by the unions and by management, once a trustee assumes the position as trustee, he or she has a duty of undivided loyalty to the beneficiaries of the plan's trust funds. Therefore, a trustee could not resist benefit improvements because of concern about the impact of those improvements on employers contributing to the fund. Many of the funds that have been chronically underfunded continue to increase benefits.

We recognize that managers of some multiemployer plans have expressed opposition to legislation imposing limitations on benefit increases because, in their opinion: (1) it is not necessary: and (2) it is intended to undermine the multiemployer pension system. The trends in certain multiemployer plans that we described above—increases in the level of underfunding, declines in the number of active employee participants, and increases in benefits—demonstrate that changes are needed if underfunding is to be reduced.

The reductions in underfunding that should result from the legislation would not undermine the multiemployer pension system as some have feared. It is not the goal of the members of our Coalition to avoid withdrawal liability. Rather, it is our goal to eliminate such liability to the extent a fund is reasonably able to do so. A reduction in underfunding would not motivate contributing employers to withdraw from a multiemployer fund, but would eliminate one of the principle reasons why employers avoid commitments that require them to join a multiemployer fund. The legislation would result in a healthier pension system for employers and employees.

As we have demonstrated, there is a problem, the problem is getting worse and it will not go away by itself. The Administration's efforts to deal with underfunding in single-employer defined benefit plans, as reflected by S. 1780, will be incomplete unless they also deal with underfunding in multiemployer plans by including Title II of S. 105. The attention now being given to single-employer plan underfunding presents a perfect opportunity for Congress to correct the chronic underfunding in multiemployer plans. Action should be taken now, while the issue of pension funding is being considered by the Congress and before plan reorganizations and insolvencies occur.

The solution proposed by Title II of S. 105 and supported by our Coalition is a simple one. The financial health of pension plans should be secured through limitations in unfunded benefit increases. Title II of S. 105 has also been endorsed by other pension experts as a necessary part of the solution of the larger underfunding problem that currently affects both single and multiemployer pension plans.

Title II to S. 105 is not a complete answer to the multiemployer pension plan problem. It will, however, help "stop the bleeding" by requiring a balance between a pension fund's financial standing and benefit increases.

Employees are entitled to rely on the pension promises that are made to them. Although potential restrictions that may arise from Title II of S. 105 might, at first

glance, appear to be unfair, these restrictions are far less unfair to employees than a system that authorizes empty pension promises.

EXHIBIT A

Multiemployer Fund	Recent Plan Year/Unfunded Vested Liability of the Plan[1]
Central States SE & SW Areas Pension Fund	1992/$1,414,416,000
NYSA-ILA Pens ion Trust Fund & Plan Board of Trustees	1991/$316,796,100
Teamsters Pension Trust of Philadelphia & Vicinity	1991/$228,828,938
Chicago Truck Drivers, Helpers & Warehouse Workers Union	1992/$86,458,300
Alaska Teamsters Employer Pension Trust	1991/$84,256,866
Western Pennsylvania Teamsters Pension Fund	1991/$70,323,139

[1] The Coalition has continued to research the funding status of multiemployer pension plans In addition to the trends in the financial conditions of the funds, as described above, our study also demonstrated that certain trends which we described in our 1991 testimony to the subcommittee on Oversight regarding the availability of information regarding multiemployer plans are continuing. Form 5500's are not available. When they are available, they are not complete or up to date. Thorough and comprehensive research is impossible. As indicated on Page 12 of The General Accounting Office's ('GAO') September 1993 Report to the Congress, the GAo has had similar problems finding information regarding the underfunded multiemployer plans.

EXHIBIT B[1]

Multiemployer Fund	Initial PlanYr./No.Active Employee Participants	Most Recent Plan Yr./No. Active Employee Participants	Reduction During Period
Central States SE & SW Areas Pension Fund	1979/427,319	1992/226,818	47%
NYSA-ILA Pension Trust Fund & Plan Board of Trustees	1984/9,174[2]	1991/4,470	51%
Teamsters Pension Trust of Philadelphia & Vicinity	1979/31,196	1991/14,170	55%
Chicago Truck Drivers, Helpers & Warehouse Workers Union	1980/6,281	1992/2,137	66%
Alaska Teamsters Employer Pension Trust	1983/9,056	1991/3,679	59%
Western Pennsylvania Teamsters Pension Fund	1979/19,664	1991/9,861	50%

[1] Statistics have been updated to include the most recent information available as of April 1, 1994

[2] Recognizing the problem, the contribution base unit measurement of this fund subsequently was changed from a man-hour basis to a tonnage basis.

COMMUNICATIONS

STATEMENT OF THE AMERICAN COUNCIL ON EDUCATION

(ON BEHALF OF THE AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES; COLLEGE AND UNIVERSITY PERSONNEL ASSOCIATION; NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS; NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES; NATIONAL ASSOCIATION OF INDEPENDENT SCHOOLS; TEACHERS INSURANCE AND ANNUITY ASSOCIATION; AND COLLEGE RETIREMENT EQUITIES FUND; AND THE VARIABLE ANNUITY LIFE INSURANCE COMPANY)

The American Council on Education (ACE) and the other educational associations listed on the cover sheet recognize the important efforts of the Chairman and the Clinton Administration to strengthen the nation's pension system through "The Retirement Protection Act of 1993" (S. 1780). ACE and the other organizations that support this statement represent the majority of the nation's colleges, universities and independent schools. These educational employers have provided secure retirement income to their employees for decades. In fact in 1972, before he introduced the "Employment Retirement Income Security Act of 1974," (ERISA) Senator Jacob Javits cited our pension plans as role models:

> We need to learn something from the success of the college teachers' retirement system, TIAA–CREF, which would be a real model for private industry.[1]

BACKGROUND

The vast majority of private and most public colleges and universities provide employees fully-funded, immediately-vested *defined contribution* retirement plans. The prevalent use of defined contribution plans, rather than defined benefit plans, as primary retirement plans for some or all of the employees of such institutions is longstanding, reflecting such considerations as portability and ease and cost of administration. Nonetheless, the principal purpose of these defined contribution plans is the same as that of defined benefit plans—to provide retirement benefits.

America has a system of higher education that is highly regarded world-wide and that gives our country a strong competitive advantage. The nation-wide pool of highly trained and mobile educators is a key factor in creating and maintaining that quality. It is that mobility that allows the free interchange of ideas and people and enables American colleges to adapt to an ever-changing environment. And it is in no small part, the nation-wide system of fully-funded, immediately vested, and fully-portable defined contribution plans that has allowed this mobile work force to exist. The reality of colleges and universities competing for the best minds in America to join their faculties forces them to recruit on a national basis. At the same time, as significant employers in their communities, colleges must offer a salary and benefits that enables them to recruit support staff in the local work force.

While initially created to meet the needs of faculty at colleges and universities, many defined contribution retirement plans have expanded over the years to include support staff. Other institutions cover academic employees in defined contribution plans and cover non-academic employees in defined benefit retirement plans. This dual approach to retirement plan design is especially prevalent in the public sector, where state legislatures have enacted Optional Retirement Plans which are defined contribution plans to enable their state universities and colleges to recruit high caliber, nationally-known faculty members while states seek to maintain coverage under the public retirement plan for all other employees.

---

[1] U.S. Congress, House, Committee on Ways and Means, *Tax Proposals Affecting Private Pension Plans: Hearings*, 92nd Congress, 2nd sess., part 1 of 3, May 1972, 121.

COPING WITH NONDISCRIMINATION RULES

Most of these defined contribution retirement plans operate under Internal Revenue Code (IRC) Section 403(b). Since the nondiscrimination requirements were first imposed on 403(b) plans by the Tax Reform Act of 1986, the Internal Revenue Service (IRS) has delayed the effective date of the full nondiscrimination regulations on tax-exempt employers until January 1, 1996. This extended period has provided the opportunity for colleges and universities to fully analyze their plans and to adjust them, if needed, to comply with the nondiscrimination requirements. During the interim, colleges and universities have to demonstrate a good faith compliance with the general nondiscrimination regulation package under IRC Section 401(a)(4). They anticipate that these regulations offer a preview of the ultimate regulations the IRS will issue for plans that operate under Section 403(b).

For some colleges and universities which have historically offered age-graded or service-graded plans or provide retirement benefits to employees under a combination of defined benefit and defined contribution pensions, the ability to use cross-testing provides appropriate flexibility to satisfy the complex and mathematically exacting rules under IRC Section 401(a)(4). If the nondiscriminatory status of such plans hinged on the dispersion of allocation rates for each testing year, the results could be both unfair and misleading. A shift in participant demographics could find retirement plans falling into noncompliance and disrupting long-standing benefit promises.

The principle underlying benefits cross-testing is fundamentally sound. A contribution at a given rate for a 55-year old employee will provide a much lower retirement benefit than the same contribution made for a 30-year old employee, who has twenty-five additional years to accumulate with compound interest. In varying ways and with varying degrees of precision, many educational and charitable institutions have designed their retirement plans in a manner that compensates for that difference. These plans are not aggressive innovations designed to give maximum advantage to highly-compensated employees. In fact, many of the highly-compensated employees who today benefit from the higher allocation rates under age-graded or service-graded plans have worked for many years before qualifying for such allocations or reaching the income threshold that defines them as highly compensated. Such plans were often designed to recognize salary compression at the upper faculty ranks and help attract other faculty to institutions.

Our basic concern is not cross-testing itself, but the pitfalls of nondiscrimination rules as complex and mathematically exacting as those in the regulations under IRC Section 401(a)(4). Fully understanding the several hundred pages of nondiscrimination rules that the IRS will apply to exempt sector plans in 1996 presents a formidable compliance burden for business and benefits officers of educational and charitable employers. Under a totally new regime that involves triennial or even annual testing—involving such nuances as rate groups, permissible measures of compensation, and benefits, rights and features—plan provisions or plan combinations that are structurally fair and nondiscriminatory will inevitably pose compliance problems. In this context, cross-testing functions as a partial antidote to the risks of a mathematical system that does not look beyond the testing results for a single plan year.

LANGUAGE OF S. 1780 IS TOO BROADLY WORDED

The higher education community appreciates the concern of the Department of the Treasury about the potential for abuse of cross-testing in "new comparability plans" and age-weighted profit sharing plans that disproportionately concentrate retirement plan benefits in the accounts of a few highly-compensated employees. However, we believe that the broad language of S. 1780 covers all defined contribution plans, not just profit sharing plans, and will disrupt the pension plan configurations that have been common in the educational and charitable sector for many years without evidence of abuse.

The risk that high contribution rates will be effectively limited to highly-compensated employees is plainly greatest for plans that cover a relatively small number of employees, especially where the contribution rates are controlled by the older and most highly-compensated employees. Such plans are almost invariably top-heavy within the meaning of IRC Section 416(g). Congress in this section of the IRC has drawn a line between plans that operate for the primary benefit of the most highly-compensated employees and other plans. The purpose of the top-heavy section is similar to that of the proposed legislation—to assure that lower-paid employees are not shortchanged by application of the normal nondiscrimination and minimum vesting requirements. Congress' conclusion that the Section 416 safeguards

are not required for non-top-heavy plans seems an appropriate policy distinction for cross-testing, as well.

ALLOW CROSS-TESTING OF NON-TOP-HEAVY PLANS

Accordingly, we recommend that non-top-heavy plans be excepted from any cross-testing prohibition. The overwhelming majority of plans are predictably either top-heavy or non-top-heavy. Thus, a non-top-heavy exception would give many employers practical assurance that they could rely upon cross-testing principles on an ongoing basis. In turn, those employers would maintain stable contribution rates and preserve employee expectations. The possibility of abuse seems remote since nonhighly-compensated employees generally comprise a significant percentage of the participants in a non-top-heavy plan, and confining the high contribution rates to highly-compensated employees would be difficult.

In recommending a non-top-heavy exception, we recognize that Section 403(b) plans are not subject to the top-heavy rules. (The participants in a Section 403(b) plan never have an ownership interest in the employer and that the plan terms are typically controlled by independent boards.) However, the non-top-heavy exception could be limited to plans that are not top-heavy within the meaning of Section 416(g), without regard to whether Section 416 is directly applicable.

OTHER APPROPRIATE EXCEPTIONS

We have addressed our concerns with this proposal in S. 1780 to the Department of the Treasury and proposed the non-top-heavy exception with three other recommended exceptions to the prohibition against cross-testing. Where any of those exceptions applied the risk of abuse would be minimal. The proposed exceptions are not conditioned on a minimum percentage of nonhighly-compensated employees qualifying for each rate of allocations each year. Any such test would be more difficult to apply and, in our view, too rigid. The three additional exceptions are:

1. Defined contribution plans combined with substantial defined benefit plans: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if it is combined with a defined benefit plan for any purpose under Section 410(b) (including the average benefits test), and the defined benefit plan serves as the primary retirement plan for at least 30 percent of the employer's employees.

2. A maximum four to one ratio of allocation rates and all allocation rates available to a nondiscriminatory classification of employees: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if (i) the lowest allocation rate for any nonhighly-compensated employee was at least 25 percent of the highest allocation for any highly-compensated employee, and (ii) under the terms of the plan, each rate of allocations was currently and effectively available to a group of employees that constituted a nondiscriminatory classification within the meaning of Section 410(b)(2)(A)(i). For purposes of determining whether a rate of allocations was currently available to an employee, age and service conditions would be disregarded. For purposes of determining allocation rates, the plan's definition of compensation would be acceptable, and imputed disparity (as well as elective and matching contributions) would not be taken into account.

3. An average allocation rate for nonhighly-compensated employees equal to at least 40 percent of the highest allocation rate for any highly-compensated employee: A defined contribution plan would be permitted to satisfy Section 401(a)(4) (as well as the average benefit test of Section 410(b)) on the basis of benefits if the average allocation rate for nonhighly-compensated employees benefitting under the plan (and any other defined contribution plan with which it is combined for purposes of Section 410(b)) was at least 40 percent of the highest allocation rate for any highly-compensated employee benefitting under the plan (or plans). For purposes of determining allocation rates, the plan's definition of compensation would be accepted, and imputed disparity (as well as elective and matching contributions) would not be taken into account.

ROUNDING THE COST-OF-LIVING

Additionally, Section 407 of S. 1780 raises some concerns for the sponsors of defined contribution plans. While rounding cost-of-living factors that applies to the $90,000 defined benefit plan limit under Section 415(b)(1)(A) in increments of $5,000 may be reasonable, applying that same $5,000 increment to the $30,000 Section 415(b)(1)(A) for defined contribution plans disturbs the four-to-one ratio established in the Tax Reform Act of 1986. Rounding the $30,000 limit in $1,000 increments

would keep a closer balance while still reducing the administrative complexity. It would also avoid shifting to defined contribution plans an inequitable share of the burden for the tax revenue lost due to enhanced plan funding requirements for defined benefit retirement plans.

CONCLUSION

In conclusion, the legislative history of the Tax Reform Act of 1986 recognized the special circumstances of higher education. Congress' intent to allow 403(b) to be combined with 401(a) plans for coverage testing indicates a recognition that flexible aggregation is appropriate. With regard to rules on comparability of defined benefit and defined contribution pension plans, for example, the *General Explanation of the Tax Reform Act of 1986* states, "Congress intended that the Secretary is to prescribe rules applicable to tax-sheltered annuities that reduce the administration burden of applying Revenue Ruling 81–102." In a similar vein, we urge Congress to maintain the availability of cross-testing for non-abusive plans of colleges, universities and independent schools.

STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The AICPA appreciates the opportunity to comment on S. 1780, "The Retirement Protection Act of 1993." The AICPA is the national professional organization of CPAs, with over 314,000 members in practice, industry, government and education. For years, the AICPA has been a strong advocate of simplification of the pension system. We believe this proposal achieves simplification in some areas, while creating complexity in others. We also believe that while this bill addresses some of the issues affecting plan funding, additional important steps can and should be taken to ensure that the necessary funds are put aside by plan sponsors to pay the benefits promised to American workers. In addition, specific measures need to be adopted to correct a shortfall in the information provided to employees about their pensions. Workers have every right to know whether their pensions are secure. Only then can they make informed choices about their retirement and their future.

Our comments and suggestions relate to several sections of the bill including the elimination of cross testing, exemption from the quarterly funding requirement and other funding criteria, exemption from the 10 percent excise tax on certain nondeductible contributions, cost-of-living adjustment rules and increased disclosures to plan participants.

ELIMINATION OF CROSS-TESTING

Section 408 of the Retirement Protection Act, proposed in 1993, would eliminate the cross-testing method for discrimination testing in qualified retirement plans. The AICPA opposes the elimination of cross testing and objects to section 408 both on tax policy and on legislative procedural grounds. First, as a matter of tax policy, the elimination of the ability to cross-test employee benefit plans would have some undesirable consequences. Second, as a matter of legislative procedure, Congress should not repeal a single element of a comprehensive set of IRS regulations that were carefully designed to implement existing law.

Tax Policy

Some in Congress may be concerned that the application of cross testing principles could result in lower contributions being allocated to younger workers. For the following reasons, however, we believe these concerns are misplaced:

- Over an individual's working life, funding for a specific retirement benefit would be the same. In the course of a worker's total years of employment, he or she would enjoy a nondiscriminatory retirement benefit.
- These concepts are fundamental to defined benefit plans designed by employers to maximize retirement benefits for the employees most in need of retirement savings, the older workers. Yet, the proposed elimination is only directed at defined contribution plans.

There has been a long-standing statutory premise that, in testing to determine whether a plan is discriminatory, the employer can prove that either contributions or benefits do not discriminate in favor of highly compensated employees. The employer does not have to prove that both contributions and benefits are nondiscriminatory. The statute does not require that defined benefit plans be tested on the basis of benefits or that defined contribution plans be tested on the basis of contributions.

The inevitable result of eliminating cross testing will, in our view, be termination of a significant number of qualified retirement plans—a substantially worse result than exists at present. The tax system includes significant and important incentives for employers and business owners to provide retirement security for employees, and we believe it critical that those incentives continue.

Legislative Procedure

After the enactment of the Tax Reform Act of 1986, the Internal Revenue Service undertook a comprehensive review of qualified plan discrimination rules. It was decided that very specific rules should detail appropriate discrimination tests. These rules resulted in over 600 pages of regulations, which were reviewed, subjected to public comment, and revised over a four-year period. These regulations outline in precise detail how a plan sponsor can test benefits to determine whether the contributions are discriminatory. These discrimination testing concepts have been in place since the issuance of Rev. Rul. 81–202.

The AICPA particularly objects to legislative repeal of one segment of an extremely comprehensive regulation project. Legislative changes such as this should be considered only as part of a deliberate review of the country's overall retirement income policy, which to date has not been considered.

PLAN FUNDING

The Act proposes reforms to improve plan funding levels, including rules that would encourage more rapid funding. In general, we applaud these suggestions and recommend that they be given serious consideration. At the same time, however, there are several current statutory provisions that discourage employers from fully funding defined benefit plans. Two such provisions are:

- The 150% full funding limitation, which disallows deductions for employer contributions that exceed 150% of "current liabilities." The term "full funding" in this context does not mean that the plan has enough funds to pay all benefits when they become due, because full funding is based on an artificial assumption of the plan terminating today and an arbitrary 150% cap.
- The 50% reversion penalty is a disincentive to fully funding defined benefit plans under certain circumstances. Under current law, these excise taxes are still applicable even if the employer uses any related reversion amounts to enhance the security of other employee benefit programs (for example, retiree health care).

Given the above, businesses desiring to improve the financial strength of their pension plans in good times are precluded or dissuaded from doing so, only to find they are not able to continue to provide the necessary funds for workers' retirements when the economy turns down.

We recognize that the Congress must consider competing interests, including tax revenue and related budget implications, adequacy of the Pension Benefit Guaranty Corporation's insurance fund, the cost to plan sponsors of providing retirement benefits and relevant labor and social policy considerations. We believe that the need for adequate funding of pension plans should be the focus of increased Congressional emphasis to ensure that participants receive promised benefits.

We understand that removing certain disincentives may result in decreased tax revenues. However, we believe that the situation is such that we must "pay now or pay later," and there is serious potential for a far greater cost to the American taxpayers if plan funding is not improved in the near term.

We believe that a comprehensive assessment should consider both the need to strengthen the minimum funding standards and the need to remove disincentives to full funding. This includes consideration of the maximum deduction limits and carryforward provisions for any excess contributions.

In the context of removing disincentives, we are pleased that section 105 of the Act eliminates the current 10% excise tax on certain nondeductible contributions to both a company's defined benefit and defined contribution plan exceeding 25% of payroll, and eliminates the same excise tax on nondeductible contributions for plans with fewer than 100 participants that fully fund all benefit liabilities upon plan termination. The AICPA strongly supports both proposals, since they will remove impediments to a full funding by employers who may have previously hesitated to maximize their contributions to a defined benefit plan because elective deferrals or matching contributions might not be deductible and could be subject to the 10 percent excise tax. Moreover, simplification is achieved as well.

The AICPA supports amendments that will encourage plan sponsors to bring all plans up to a true full funding status. The AICPA believes such changes should be a high priority for the Congress and is willing to assist the Congress in identifying

and analyzing potential legislative proposals designed to achieve the full funding objective.

EXEMPTION FROM QUARTERLY FUNDING

Section 104 of the Act repeals the requirement for quarterly contributions to fully funded plans. The AICPA supports this proposal since it would achieve simplification for many employers. Currently, employers who contribute too much on a quarterly basis need to file a ruling request with the IRS to receive a refund of the nondeductible contribution to the plan.

AMENDMENTS TO ROUNDING RULES

Section 407 of the Act changes the rounding rules for annual cost-of-living adjustments to the section 415 limits on contributions ad benefits and to the elective deferral limits. The $90,000 defined benefit and $30,000 defined contribution dollar limitations under section 415 would be indexed in $5,000 increments; the $7,000 limit on elective deferrals would be indexed in $500 increments. In principle, the indexed amount would be adjusted by rounding to the next lowest multiple (but never up). For example, if this provision were to be effective in 1994, the limit on elective deferrals, which is $9,240, would be held at $9,000 until the indexed amount would otherwise exceed $9,500. We recommend rounding to $100 increments.

Although this provision appears to simplify pension administration, we are concerned that it is being used as a back-door attempt to generate additional revenue. Worse, it is becoming clearer that this is deliberate governmental policy. The 1993 Budget Reconciliation Act, in applying the new $150,000 compensation cap for qualified plan purposes, also required indexing in increments, rather than annually. Since indexing provisions affect the amount ultimately received by retired workers, and since indexation has traditionally been an annual event (for social security COLAs, bracket creep, and even (before 1994) for compensation taken into account for qualified plan purposes), we believe a shift to a more restrictive approach—without a good deal of education of the taxpaying public—is inappropriate.

DISCLOSURES TO PLAN PARTICIPANTS

We support section 301 of the Act, which calls for increased disclosures to defined benefit pension plan participants about their plan's funding status and the limits on the Pension Benefit Guaranty Corporation's (PBGC) guarantee should the plan terminate while underfunded. However, we believe that all plan participants should receive additional information about their plans. We emphasize the word "all" because we believe such disclosures should be made to plan participants whether the plan is underfunded or fully funded. Accordingly, we recommend revisions to existing sections of ERISA which are discussed in the following paragraphs.

Most employees do not receive their benefit plan's detailed annual financial statements, which are filed with the U.S. Department of Labor. Instead, they look to the Summary Annual Report (SAR) to obtain financial information about their plan. ERISA section 104(b)(3) requires plans to furnish participants with a SAR, and section 2520.104b–10 of the DOL's Rules and Regulations sets forth the required form and content of the SAR. However, the SAR does not currently include information critical to evaluating the plan's financial health and ability to meet its obligations to participants. The information that is provided, moreover, is often in a format that is difficult to understand. The AICPA believes that the requirements for the form and content of the SAR should be expanded and should be included in ERISA section 104(b)(3). We have a number of recommendations to make the SAR more informative and easily understood by employees.

Specifically, the SAR should:

- Disclose the total amount promised to plan participants in the form of benefits, the accumulated benefit obligation, as well as key actuarial assumptions used to calculate that—obligation. Right now, the SAR discloses the plan's assets but not its obligations. Seeing only the amount of assets the plan has, but not how much it owes, the employee cannot possibly assess the plan's financial condition.
- Explicitly disclose the funding status of the pension plan. For example, if the obligations of the plan exceed its assets, the SAR should say that the plan is underfunded and by how much.
- Disclose the maximum monthly benefit guaranteed by the PBGC. If for any reason a pension plan can't make good on its obligations—for example, because the company goes bankrupt or out of business—the worker's last recourse is the PBGC, the government's insurance policy for pension plans. However, this in-

surance doesn't always cover all the benefits owed to the employee. The SAR for a defined benefit pension plan should provide a description of the PBGC's coverage, specifying any limitations or benefits excluded.

- Disclose if the employer is having financial trouble that could impair its ability to contribute to the pension plan and if the pension plan's assets are concentrated in certain high-risk or illiquid investments.
- Include information on the right of every plan participant to request information on his or her individual benefits once per year.
- Notify the participant of a report by the independent auditor on the plan's financial statements that is other than an unqualified opinion or a disclaimer of opinion in a limited-scope audit under section 103(a)(3)(c) of ERISA.

Information provided in the SAR about the plan itself is not the only information that is relevant to pension plan participants. The information of greatest interest to a defined benefit pension plan participant is how much the plan will pay him or her in retirement. However, current ERISA section 105(a) requiring pension plans to provide participants with individual benefit information doesn't apply to all defined-benefit pension plans. ERISA section 105(d) calls for the Department of Labor to issue regulations to make this requirement applicable to multi-employer pension plans. The Department has issued proposed regulations in 1979 ad again in 1980, but it never finalized them. Accordingly, members of multi-employer plans may not have the right to individual benefit information. We recommend that ERISA section 105(d) be deleted to make section 105(a) apply to all defined-benefit pension plans.

In addition, the current rules allow an excessively long delay between the time a major change to a pension plan is adopted and the time the employees learn about it. ERISA section 104(b)(1)(B) requires pension plans to furnish employees a "summary description of plan amendment" not later than seven months alter the end of the plan's fiscal year in which the change is adopted. In the extreme case, if a change is adopted on the first day of the plan year, the plan participants would not have to be notified for 19 months.

A pension plan amendment might change the amount of benefits promised by the plan's sponsor; or it might change the plan's sponsor—the company responsible for making contributions to the fund; or the plan administrator—the party the employee sees to exercise his or her rights under the plan. Workers shouldn't have to wait as much as a year and a half to learn of those changes.

Because plan amendments may significantly affect participants' benefits or the stewardship of the pension plan, ERISA section 104(b)(1)(B) should be amended to require notification of plan amendments no more than 90 days alter the change is adopted. Further, the rules should clarify what changes are significant enough to warrant such notification.

Statement of the Associated General Contractors of America

The Associated General Contractors of America (AGC) is a national trade association of almost 33,000 firms, including 8,000 of America's leading general contracting companies. AGC member firms are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development. Many AGC member firms compete for work in many different states and localities.

AGC welcomes the opportunity to provide this statement to the Senate Finance Committee on S. 1780 and H.R. 3396, pension reform legislation. AGC member firms that provide pension benefits do so through a range of options, including defined benefit and defined contribution plans, as well as single employer and collectively bargained multiemployer plans.

AGC supports the efforts of the Chairman, and those of Congressman Pickle (D-TX), Chairman of the Oversight Subcommittee of the House Ways and Means Committee as well as Congressman Pat Williams (D-MT), Chairman of the Labor-Management Relations Subcommittee of the House Education and Labor Committee to strengthen the nation's defined benefit pension system. Moreover, AGC supports Congressional efforts to address the growing financial problems posed by both underfunded single employer plans and a significant number of underfunded multiemployer plans—without jeopardizing the continuing participation of employers in well-funded multiemployer plans.

Prudent Federal fiscal management dictates that Congress act responsibly in addressing PBGC's approximately $2.9 billion deficit, which is growing according to

the latest Congressional Budget Office (CBO) report "Controlling Losses of the Pension Benefit Guaranty Corporation, January 1993." AGC believes that the PBGC program shortfall should be addressed without resort to taxpayer financing. The CBO study emphasizes that PBGC's deficit is confined to single employer plans. According to CBO, collectively bargained multiemployer plans account for less than 1% of PBGC claims. This finding is reinforced by PBGC's 1993 Annual Report, as follows:

> "The multiemployer program, which covers about 9 million participants in about 2,000 insured plans, is funded and administered separately from the single-employer program and differs from the single-employer program in several significant ways. The multi-employer program covers only collectively bargained plans involving more than one unrelated employer. In addition, the event triggering PBGC's guarantee and payment of benefits under the multiemployer program is the inability of a covered plan to pay benefits when due, rather than plan termination as required under the single-employer program. PBGC provides financial assistance through loans to insolvent plans to enable them to pay guaranteed benefits.
>
> ". . . These safeguards have permitted PBGC to maintain multiemployer premiums at a constant, reasonably low level. The program continues to have growing assets, low liabilities, and a healthy surplus."

While we would agree with this assessment overall, we would also contend that there is an alarming trend toward increasingly problematic underfunding in many of the multiemployer funds. Many multiemployer funds are and remain less than 85 percent funded. And in fact, according to the PBGC's own estimates, the rate of increase in underfunding in multiemployer plans between 1990 and 1992 may actually be greater than the rate of increase in underfunding in single-employer plans over the same period of time.

AGC's most recent inventory of construction industry multiemployer plans confirms the CBO and PBGC findings, showing that fully 86.7 percent of all construction industry multiemployer plans in Plan Year 1990 were fully funded at a ratio of 1.00 or greater (plan assets to vested benefits). (Draft Data, *AGC-CLRC Inventory of Construction Industry Multiemployer Pension Plans, Plan Years 1987–1990.)* However, the draft data also shows that the percentage of construction industry plans that are over-funded (a ratio of 1.50 or greater) declined in Plan Year 1990 to 18.8 percent, down from 22.2 percent of construction industry plans that were funded at 1.50 or greater in Plan Year 1987. This decline may be attributable, at least in part, to declining interest rates and the impact of the 1987 Omnibus Budget Reconciliation Act, which denies tax deductions and places an excise tax of 10 percent on contributions to plans funded at a ratio of 1.50 or above:

Even with improvements in the funding status of construction industry multiemployer plans generally, there remain a significant number of large underfunded plans in this industry that PBGC should recognize. Since 1990, factors including the recession, a continuing decline in the contribution base, falling interest rates and weaker investment return indicate underfunding in multiemployer plans has grown. Data from AGC's 1990 inventory generally support the assumption that underfunding in multiemployer plans is worse today than it was in 1990. This trend may increase without Congressional action.

Following is a list of construction industry multiemployer funds with the greatest underfunding for Plan Year 1990, taken from draft data compiled from Department of Labor computer tapes of IRS pension plan reporting forms (Form 5500).

CONSTRUCTION INDUSTRY MULTIEMPLOYER PENSION FUNDS WITH GREATEST UNDERFUNDING

	Unfunded vested liability (millions)	Funding ratio
Laborers—Southern California	$410.1	61
Pipefitters/Plumbers	79.7	.84
Teamsters—Western Pennsylvania [1]	71.4	87
Carpenters—Buffalo	37.8	47
Teamsters—Central Pennsylvania [1]	36.2	95
Operating Engineers—Syracuse	29.6	86
Teamsters—Philadelphia [1]	27.3	58
Operating Engineers—New York City	25.8	81
Laborers— Massachusetts	23.0	94
Sheet Metal Workers—New Orleans	14.7	22

[1] Teamsters funds include workers not in the construction industry

While the amounts of unfunded vested benefits listed above remain high in absolute terms, they nevertheless represent a marked improvement compared with underfunding overall in previous years. To a certain extent, underfunding in construction industry multiemployer plans has been eliminated through disciplined labor/management administration. Where underfunding persists, AGC policy supports legislation that would prevent increases in benefits by underfunded plans.

AGC supports the recommendations of the Advisory Committee of the Pension Benefit Guarantee Corporation on advance funding of pension benefits, urging that "minimum funding requirements should be strengthened, impediments to advance funding should be eliminated, and plans should be given the ability to fund aggressively when financially able to do so." Similarly, AGC supports consideration of options put forward in the CBO study, including tighter [minimum] funding rules, increased co-insurance, and risk-based premium assessments.

AGC urges Congress to avoid the mistake of raising premiums on well funded single and multiemployer plans. In fact, the multiemployer program has shown steady gains and will remain "financially strong," according to the PBGC, with a surplus of $280 million at the end of FY 1993. Since the 1980 changes in multiemployer regulations, PBGC has not paid a single claim related to a construction industry multiemployer plan. The current premium of $2.60 per plan participant for multiemployer plans is fully five times the $.50 per participant rate originally required by PBGC. Congress must recognize that continual increases in the incremental costs of employment have immediate impact on employment and earnings levels.

Moreover, both CBO and the PBGC Advisory Committee advise against raising the premiums of well-funded plans to cover the risks imposed by underfunded plans. CBO notes that such "cross subsidies" will drive well-funded plans from the program. Likewise, the PBGC Advisory Committee counsels that "premium increases should be viewed with caution due to the potential that they could induce over-funded defined benefit plans to terminate."

In order to protect the expected future benefits of today's workers, Congress should enact pension reform legislation that does not deter employers from willingly participating in multiemployer plans. The Administration's proposal, H.R. 3396, will incompletely reform the whole system as it only focuses on underfunding in the single-employer system. AGC supports pension reform legislation that protects employees and employers who participate in multiemployer pension plans.

Specifically, the solution proposed by Congressman Pickle's House Ways and Means Committee Subcommittee on Oversight requiring either "cash or collateral" is a simple one. The financial stability of the multi-employer system would be enhanced and secured through limitations in unfunded benefit increases. Other proposed solutions, such as increasing PBGC premiums, will not necessarily reduce pension plan underfunding, especially in multiemployer plans.

AGC appreciates the opportunity to comment on some of the elements of the PBGC's financial reform pending in Congress. AGC will continue to monitor developments on this issue and remains willing to work with Congress in addressing these fundamental issues and enacting sound pension law reform. We urge the Chairman of the Finance Committee, and Congress, to continue to closely monitor total underfunding in multiemployer plans.

Statement of Champion International Corporation

(BY TERRELL G. WOMACK, VICE PRESIDENT OF EMPLOYEE BENEFITS AND SERVICES)

Mr. Chairman and Members of the Committee, on behalf of Champion International Corporation and our 20,000 employees, I submit the following comments on S. 1780, The Retirement Protection Act of 1993. I am Terry Womack, Vice President of Employee Benefits and Services for Champion International Corporation.

Champion is a major producer of paper and wood products with facilities in 34 states. We are a strong and healthy company with total assets exceeding $9 billion and net worth exceeding $3 billion. To help ensure our long-term viability as an internationally competitive company, Champion has invested over $6 billion in capital improvements during the past nine years. These investments are already paying off in terms of increased productivity and improved environmental quality for the communities in which we operate. Our commitment to a sound, long-term future is also evidenced by aggressive reforestation efforts where some trees we plant today will not be harvested for another 50 years.

We are firmly committed to ensuring the welfare of our employees. This is evidenced by the generous level of benefits we provide, including defined benefit pensions, defined contribution plans with company matches to encourage savings, and

health, disability, and life insurance coverages. Our commitment can be further evidenced by our history of retaining pension liabilities for divested locations in order to ensure the security of even former employees.

We currently have two, well funded defined benefit pension plans with assets that together total over $1 billion. The plans cover over 60,000 participants, of which 20,000 are already retired. On an IRS basis our plans are 125% and 1 15% funded, while on the PB&C's basis our plans are 97% and 93% funded. Champion is currently exempt from all PBGC variable premiums normally imposed on plan underfunding because we are fully funded by IRS standards. The IRS is also limiting our contributions since we are considered fully funded and have been for the past 4 out of 5 years. We are very confident that neither of these plans poses any risk to plan participants or to the PB&C in the foreseeable future. Champion hopes to continue using defined benefit pension plans to provide a significant portion of retirement benefits to our employees.

I. GENERAL OVERVIEW

The purpose of this hearing is to review the administration's proposal to reduce the risk to plan participants and to the PB&C from poorly funded pension plans. Champion fully supports this goal. However, we do not believe that S. 1780 will accomplish this objective in its current form. We believe the proposal is overly broad and places unreasonable burdens on sponsors of responsibly funded plans. It unnecessarily adds further complexity to the rules and makes it more difficult for all plan sponsors (both fully funded and underfunded) to predict future funding requirements. We believe the objectives of the PBGC and the Congress can be better met by making only those changes to the current rules that narrowly focus on problem companies and the specific risks they pose as plan sponsors.

Over the years, privately sponsored, defined benefit pension plans have relieved the Federal Government of a significant burden. We believe that defined benefit pensions still provide the best retirement protection available to employees. However, as more legislation is imposed, the responsibility of funding and administering these plans is becoming overly burdensome for corporate plan sponsors. We believe that any changes should be carefully designed to avoid pushing responsible employers further away from defined benefit arrangements.

From our vantage point, one real problem is the dichotomy of perspectives between business planning, the IRS, and the PBGC. Most businesses fund pension plans like other investments—on a long-term rather than a short-term basis. The IRS evaluates pension plans on a long-term, ongoing basis while the PBGC continues to focus on a short-term, terminating plan basis. Ironically, the struggle between the IRS and the PBGC perspectives can sometimes result in responsibly funded plans sponsored by healthy companies being named to the PBGC's annual list of the worst funded plans in the country! At the same time, many poorly funded plans are not listed even though they pose a much higher risk of default.

The appropriate perspective for each plan should be based on its level of underfunding and on the economic health of the company and its outlook for future prosperity. Otherwise, companies like Champion will continue to be caught in the struggle between long-term measures used by the IRS and short-term measures used by the PBGC. The only provision that currently bridges this gap in perspectives is the exemption from variable PBGC premiums for those plans considered fully funded by the IRS. Any final legislation must preserve this exemption, as does S. 1780, in order to encourage responsible funding policies of plan sponsors.

Since the focus of any successful corporation needs to be on long-term prosperity, any short-term measures used by the PBGC should be adjusted for that specific use. For example, short-term measures are necessary in plan terminations. In trying to predict the potential exposure that any plan poses to the PBGC, these measures should be tempered with the probability of plan sponsor default. Short-term measures have no real meaning without dual consideration of the economic health of the sponsor. Therefore, the PBGC needs to develop solvency factors that consider both plan and plan sponsor health and then incorporate these factors in its short-term measurements.

Both the Top 50 list and any further PBGC legislation should sharpen the focus on truly problem plans and more accurately reflect the relative risk posed to the PBGC and plan participants by the particular company. More complicated and more stringent funding requirements for all plans or increased premiums, which are excessive relative to the risk posed by the particular company, are not warranted and should be avoided.

We are concerned about a number of items in the proposal as it stands. We believe the following provisions are insufficiently targeted in that they will not only

impact poorly funded plans but will also hurt sponsors of responsibly funded plans. In the interest of focusing on the real problem at hand, we believe that adjustments should be made to the following provisions of S. 1780:

- the restriction on actuarial assumptions used for current liability,
- the proposed treatment of negotiated benefit increases, and
- the planned increases in PBGC premiums.

Each of these provisions is addressed separately below in terms of our concerns and some suggested changes which would help focus the provisions on poorly funded plans.

II. ACTUARIAL ASSUMPTIONS FOR CURRENT LIABILITY

The measure of current liability was first introduced as part of the Additional Deficit Reduction Contribution rules. These rules require that additional contributions be made to poorly funded plans. As it stands, current liability must be calculated with an interest rate that is within a corridor defined by the IRS. As market interest rates drop, so do the rates in the corridor for current liability. Since interest rates are volatile, current liability for many plans will be overstated and artificially high because of temporary drops in interest rates. Consequently, more and more plans are being subjected to these additional contributions even though interest rates are now starting to rise. S. 1780 proposes to further restrict the assumptions available for this calculation by both narrowing the range of allowable interest rates to a lower level and mandating the use of a single mortality table.

Our Concerns

We disagree with both the narrowing of the corridor for allowable interest rates and the mandated mortality assumption in S. 1780. It is unreasonable to judge the liability of all plans on such a narrowly defined set of assumptions. Plans vary in many ways, and these variations need to be considered in determining appropriate assumptions. Some facts that must be considered include the demographics of the plan population, the size of the investment pool, the chosen investment policy, the past experience of the plan, and the health of the plan sponsor. Under current law the PBGC has a claim against the net worth of a company, which in Champion's case is more than $3 billion. Even on the PBGC's short-term basis, our plans are only $64 million underfunded and could easily be supported by our net worth.

Is it appropriate to value a short-term liability with the same interest rate as a long-term liability? We think not. Wide variations exist in the make-up of plan liabilities and the health of plan sponsors that would result in variations in suitable interest rates. S. 1780 puts even more emphasis on volatile, short-term interest rates. Plan sponsors that pose no real risk of termination in the near future should not be burdened with the unpredictability of short-term interest rates. We need to run our company based on a sound, long-term business plan, which in turn requires that both our labor and production expenses be predictable to every extent possible.

On a long-term basis, Champion's pension plans are 120% funded in total. On a short-term PBGC basis, this translates to 95%. Given the volatility in short-term interest rates, our funded ratio on the PBGC's basis can fluctuate significantly. For example, the change in interest rates alone from 1992 to 1994 increased our liabilities by over 20% or $200 million. Funding that increase in liabilities over a short period would prove to be a significant and unnecessary burden to Champion under the proposed rules. When interest rates begin to rise (as they now appear to be), we will be considered overfunded and our contributions will be restricted. Why should we be subjected to volatile contribution requirements when these short-term measures have no real bearing on the long-term viability of the plan? In the meantime, these unnecessary contributions based on short-term interest rates would have deprived our business of capital normalcy available for reinvestment toward company growth, increased wages, or increased return to shareholders. One goal in designing funding rules should be to make the contribution requirements predictable, instead of having them fluctuate erratically with temporary changes in interest rates. The only way to accomplish this is to focus on long-term expectations.

In addition to variations in interest rates, appropriate variations also exist for mortality assumptions. There are real differences in mortality rates among different classifications which are evidenced by insurance company experience. A valuation is intended to provide the best estimate of the cost of future benefits for the specific population of plan participants. Clearly then, the same mortality table and interest rate cannot be appropriate for every plan. It would be a grave public policy mistake if all valuations were required to be performed with the same set of assumptions.

Suggested Changes

Any changes to current law should be narrowly focused to affect only truly underfunded plans and the specific risks to the PBGC and plan participants. PBGC short-term, plan termination type measurements must be adjusted to reflect the funded status and the probability of actual plan sponsor default.

For example, a plan that is $1 million underfunded, but 99 percent funded does not pose a significant risk to the PBGC and should not be forced to make additional deficit reduction contribution through restrictive interest rate and mortality assumptions. However, a plan that is $1 million underfunded and only 50 percent funded, does arguably pose a risk and should be forced to make additional deficit reduction contributions.

Retaining the current law interest rate corridor for current liability measurement provides needed flexibility to ensure that well funded plans are not needlessly forced to over-fund pension plans when interest rates temporarily decline and the ensuing requirements that are triggered when a plan is considered to be underfunded under S. 1780.

Additionally, Congress should not generally mandate mortality assumptions unless a plan does not have sufficient historical experience to eve at a sound actuarial assumpilon. Broad actuarial tables on mortality of the population as a whole are not necessarily accurate for a particular plan's population and should not be mandated when better, more accurate information is available.

If Congress believes poorly funded plans should be subject to tighter cor.trols on interest rate assumptions for current liability and mortality assumptions, then a safe harbor should be provided so that only truly underfunded plans will be affected by the legislation. Plans that are 90 percent or more funded under current I.R.C. §412(b) standards should not be subject to the changes in current liability interest rates or the mandated mortality assumptions.

Finally, Congress should direct the PBGC to change its methodology in determining the companies appearing on public lists of underfunded plans, such as the Top-50 list. Under current methodology, it is possible for even well funded plans to be listed and misrepresented as posing a threat to PBGC or plan participants. Companies are currently chosen based solely on the dollar amount of underfunding on a PBGC short-term basis. Even if interest rate reductions have a similar percentage impact on two plans, the dollar increase in underfunding will be greater for the larger plan. For example, a 1% decrease in funded status for Champion translates to over $10 million in additional liabilities. This can result in even well funded plans being included on the list due to their size and the leveraging that takes place in a low interest rate environment. This list should be more clearly focused on problem plans by incorporating the plan funded ratios in the criteria for listing companies. Again, a safe harbor should be provided to ensure that plans that are at least 90% funded under I.R.C. §412(b) are not listed since these plans pose little or no risk to PBGC or plan participants.

III. NEGOTIATED BENEFIT INCREASES

S. 1780 requires that liabilities for funding include all negotiated future benefit increases. Under current law only those benefit provisions that are currently in place need be considered.

Our Concerns

We believe it would be inappropriate to require that all negotiated benefit increases be reflected in the liabilities for immediate funding when they are not currently effective. Why? Because these benefits have not yet been earned and are not yet available to new retirees. If a sponsor were forced to terminate a plan before the effective date of a negotiated benefit structure, these benefits would not necessarily be fully protected under ERISA or guaranteed by the PBGC.

Since we do not foresee any plan terminations in Champion's future, we are mainly concerned with appropriately matching expense against income. Currently we pay for the cost of negotiated benefit increases over time with corresponding price and productivity increases on our paper products. It would be unfair and harmful to our business to charge Champion for the benefit increases before we can offset them with price and productivity increases. Any premature reflection of expense in our product prices would jeopardize our competitive standing internationally.

We have a similar problem with any requirement to collateralize negotiated benefit improvements, other than for very poorly funded plans. Any requirement mandating early recognition of future increases could force us into shorter labor contracts. Shorter contracts would clearly diminish the continuity necessary to foster our team environment, which we believe is necessary to maintain a highly competi-

tive market position. This effect on a widespread basis would be detrimental to the overall stability of our economy.

Suggested Changes

A much more direct and logical way to promote faster funding of negotiated benefit increases would be to require that the associated increases in liability be amortized over the average remaining service of the affected employees (generally 12–18 years), instead of the 30 years currently allowed for all plan amendments. This would avoid recognition of future benefits that are not yet available but would still hasten the funding of these newly created liabilities for past service. It would also help us maintain a reasonable connection between the expense of doing business and the income flow associated with that business.

IV. PBGC PREMIUMS

Currently PBGC premiums consist of a $19 per person charge plus an additional $9 charge per $1,000 in underfunding per participant. The total annual charge is capped at $72 per person. S. 1780 would continue this structure, but remove the $72 cap.

Our Concerns

We fear that the PBGC premiums for well funded plans may become excessive if the current $72 cap is removed from the variable rate portion. The intention of removing the cap is to fully recognize in the premiums the underfunding in poorly funded plans: removing the cap could provide further incentive for sponsors of these plans to strengthen their funding policy. These are admirable purposes, but they need to be accomplished more deliberately so that sponsors of responsibly funded plans are not also penalized.

Removing the cap leaves even well funded plans with unpredictable exposure. If interest rates drop drastically, most plan sponsors will be subject to large increases in variable premiums, due solely to temporary market conditions; and there is no direct benefit derived for the plan or plan participants from these unnecessary premiums. Currently that exposure is capped at $72 per person which gives employers at least some certainty. Removing the cap without somehow factoring in the viability of the plan sponsor would again be penalizing all plan sponsors for the unpredictability of short-term interest rates, even where they have no *real* application.

Suggested Changes

We believe the premium cap should not be removed for well funded plans. If, however, Congress accepts the general direction of the PBGC's recommendation, we would strongly urge Congress not accept the method in which PBGC has proposed to increase premiums. Any premium increase structure should not penalize responsibly funded plans that are caught by temporary fluctuations in interest rates.

One option would be to allow well funded plans to pay any premium amount in excess of the $72 level to their plans instead of to the PBGC. At least this way plan participants would derive some benefit from the use of short-term measurements by the PBGC.

In Summary

Champion supports the general goals of S. 1780. We believe that responsibly funded, defined benefit pension plans provide important security to employees. We believe the majority of plan sponsors are taking this responsibility to heart and are acting in the best interest of their employees.

To preserve the security of our employees, we must also concentrate on our viability as an employer. In order to do this we need to make significant investments in both the manufacturing assets of the corporation and the training and development of our employees. To do that efficiently we need our expenses to be as predictable as possible so that they appropriately match our income. We ask for your help in providing some certainty to our pension contributions and premiums by using long-term assumptions for generally healthy companies and plans.

In some cases, plan sponsors have taken their commitment too lightly by allowing their plans to become severely underfunded. However, the burden for these companies should not be shifted to responsible companies or to the government. Instead, we need a fair way to identify these companies and force them into further funding to improve plan security. The best way to accomplish this is through incorporation of solvency measures both for pension plans and their sponsors in all short-term measures.

Statement of the Committee on Employee Benefits

PRINCIPLES FOR REFORM

FEI's Committee on Employee Benefits has reviewed the Clinton Administration proposal, The Retirement Protection Act of 1993 (H.R.3396/S. 1780), on reforming the pension system. CEB strongly believes that plan sponsors should responsibly fund their defined benefit plans in order to fulfill their benefit promises. In reviewing PBGC legislation, CEB has established the following set of principles for PBGC reform:

- Funding should be accelerated for new amendments to underfunded plans. Guarantees for these increased benefits should accrue over a time frame that is similar to the funding period.
- Changes in funding rules should be primarily prospective.
- Funding rules must balance volatility against the need for increased funding.
- In order to encourage funding, employer's ability to make tax-favored pension contributions should be increased, thereby reversing recent trends to reduce or limit the deductibility of employer contributions.
- Shut down benefits should be reimbursed to the pension plan as soon as possible.
- Contributions should be increased to reduce current liability underfunding in a manner that addresses the problems caused by double counting of gains and losses and removes the possibility of abuse.
- The current open-ended PBGC guaranty needs to provide appropriate limitations and exclusions.
- Pre-petition and post-petition required contributions should be given priority status in bankruptcy.
- Premium increases should not be considered as a solution.
- Actuarial assumptions should not be rigidly mandated in statute, but should continue to reflect individual plan circumstances.

We are in agreement with many of the goals of the Clinton Administration proposal. We agree that funding must be increased in underfunded plans; that better opportunities must be made available to underfunded plans that have the money to "fund up;" that companies should not be able to avoid pension contributions during bankruptcy; that shut down benefits should not be allowed to drain a pension plan's assets. However, we differ very significantly on the appropriate ways to achieve these goals. Furthermore, we disagree with the PBGC on the need for a premium increase, the proposed reduction in 415 limits, and the intrusion of the PBGC into sensitive merger and acquisition negotiations.

A discussion of significant areas follows:

FUNDING REQUIREMENTS

CEB strongly believes that plan sponsors should fund their pension plans in order to meet their plan commitments. However, we are concerned by certain items in the Administration's proposal that could increase short term volatility in cash flow, jeopardizing the long term commitment of sponsors to maintain defined benefit plans.

CEB opposes the Administration proposal to specify mortality assumptions and reduce the range of current liability interest rates. Mortality should represent the actuary's best estimate of the actual experience of the plan population, not a standard that is based on an entirely different population group. In combination, the Administration interest and mortality proposal could significantly overstate the liability of the plan at termination, causing mature plans with sufficient assets to continue to make unneeded contributions.

The Administration proposal focuses on the provisions of the law that determine contributions as a percentage of unfunded current liabilities. This amount does not distinguish between items under the sponsor's control (e.g., new benefit promises) and short term gains and losses. There is a potential for significant annual fluctuations in the unfunded current liability value that are not significant in the long term view of plan funding. CEB believes that the appropriate focus should be primarily on new benefit promises. If the Administration approach is to be followed, caps on contribution volatility must be adopted that minimize short term fluctuations in cash flow due to items not under the sponsor's control.

CEB supports the Administration proposal to maintain a minimum level of liquid assets in the least well funded plans. However, we believe that the definition of liquid assets must be carefully defined to avoid anomalous results (e.g., in plans that have insured benefits).

CEB believes that the proposal should not apply retroactively. Companies have planned for capital needs on the basis of current law. We agree that, under the ap-

proach taken by the Administration, it is important to eliminate double counting of gains and losses, but on a prospective basis. Prospective application of the elimination of double counting is primarily a transition rule, since double counting of gains and losses will wear off rapidly over the next 4 to 7 years.

Finally, CEB believes that legislation should give positive incentives for better funding of underfunded plans. Under the Administration proposal, the requirements for funding a percentage of current liability costs are significantly accelerated for relatively well funded plans, but unchanged for plans that are funded at less than 35 percent. CEB believes that requirements on plan sponsors should become less onerous as plans become relatively better funded.

REDUCTION IN FUNDING OPPORTUNITIES

CEB strongly believes that plan sponsor's ability to make pension contributions should be strengthened. The Clinton Administration proposal would carefully preserve the ability of plan sponsors to prepay required contributions. We support that provision strongly; it is important that plan sponsors be given the opportunity to prepay contributions in good times, so that the money will be available to the pension plan in bad times.

The Administration proposal also embodies measures to remedy flaws in the law that allow sponsors of plans with assets less than 100% of current liability to "fund up" their plans to the 100% level. We think the measures in the proposal are a step in the appropriate direction but insufficient. The problem arises when a sponsor maintains both a pension and a savings plan. Under current law, a plan sponsor that wishes to "fund up" the pension plan may not be able to deduct contributions to the savings plan and may incur an excise tax on the nondeductible contribution. The Administration proposal would remove the excise tax for sponsors that maintain both a savings plan and an (underfunded) pension plan, but does not provide that the contribution to the savings plan is deductible. To the extent that the savings plan contribution represents reasonable compensation, CEB strongly believes that the contribution should be deductible.

Finally, the Clinton Administration proposal would reduce 415 limits by rounding them down, further constraining the ability of sponsors to appropriately fund future liabilities. We believe that there are other more appropriate ways to raise needed revenue—such as simplification and extension of the ability of plan sponsors with excess assets to use those assets to provide other employee benefits. (An example of such a provision is in IRC 420, allowing plan sponsors with excess pension assets to use those moneys to provide retiree medical benefits.)

PBGC GUARANTY

CEB believes that the PBGC should continue to guarantee defined pension benefits. However, the current open-ended PBGC guaranty needs to provide appropriate limitations and exclusions. Of course, any limitations on PBGC's guaranty of prefunded benefits should be prospective.

We believe that contingent benefits that increase or cause underfunding (e.g., shutdown benefits) should not be guaranteed. We believe that the moral hazard inherent in allowing plans to grant benefits which are guaranteed in five years but funded over 30 years should be stopped.

We also believe that the period over which guarantees accrue should be linked to a reasonable period in which to fund the plan.

The Clinton Administration proposal would further reduce the linkage between guarantees and funding. This is particularly evident in the shortening of the period over which guarantees accrue for partial owners of plan sponsors, who well may have participated in plan funding decisions. CEB believes that it is inappropriate to increase the disparity between the period allowable for funding a plan improvement and the period over which that benefit improvement is guaranteed.

TREATMENT OF PENSION OBLIGATIONS IN BANKRUPTCY

CEB believes that the bankruptcy code should not encourage the transfer of pension liabilities to PBGC rate payors. We believe that pre-petition and post-petition required contributions should be given priority status in bankruptcy. ERISA priority status should be expressly adopted in the federal bankruptcy code. The Clinton Administration proposal does not directly address this area; we believe a separate bill should be proposed to deal with these important issues.

PREMIUM TAX INCREASES

The Clinton Administration proposal would remove the cap on the variable rate PBGC premium. CEB does not support an increase in PBGC premiums. Given reform, it is not clear that the increase in premium is needed for the PBGC to fulfill its obligations. It doesn't make sense that when PBGC's liabilities are decreased by reform the PBGC should need larger premium collections.

Overall CEB is opposed to increases in PBGC premium for general revenue collections. Any increases in PBGC premium must be directly linked to an evaluation of the PBGC's long term assets and liabilities.

NOTICE TO PARTICIPANTS

CEB recognizes that there is a need to better inform participants about PBGC guarantees and the extent of unfunded benefits before a plan termination that results in loss of pension benefits. However, we cannot accept the Clinton Administration disclosure proposal, which would be triggered on the basis of unreasonable assumptions in a format as yet unknown. We would like to work with the Administration and the Congress to come up with a workable method for providing this information that is based on commonly available and accessible information such as the disclosure of vested and accrued benefit obligations that are required under FAS87 (and monitored by the SEC).

PBGC ROLE IN MERGERS AND ACQUISITIONS

The Clinton Administration proposal would intrude the PBGC into the sensitive arena of merger and acquisition negotiations. We believe that it is inappropriate to provide this authority to the PBGC. Under current law (ERISA §4069) the PBGC already has the authority to pursue abusive transactions that are entered into to evade liability to the PBGC for an underfunded pension plan.

The imposition of the Clinton Administration proposal would likely be counterproductive. Addition of another party to merger and acquisition negotiations in and of itself will close off the opportunity for many such transactions and increase the costs of those that proceed. This reduces the market value of operations held by a sponsor that has any underfunded plan, thereby reducing the ability of a troubled sponsor to access capital needed to stay in business and ultimately fund pension obligations.

FINANCIAL EXECUTIVES INSTITUTE'S COMMITTEE ON EMPLOYEE BENEFITS

Financial Executives Institute's Committee on Employee Benefits is the policymaking body for FEI on benefit issues. The Committee's members represent a broad cross section of financial executives from mid-sized to Fortune 50 companies who administer over $226 billion in defined benefit assets. Financial Executives Institute, the leading advocate for financial executives, has over 14,000 members from over 8,000 companies.

STATEMENT OF LOEWS CORPORATION

Loews Corporation would like to comment on what we believe to be a very limited problem under existing law, which will be exacerbated by the Retirement Protection Act of 1993 ("the Bill").

Loews generally supports the efforts of Congress to further secure the private pension system and to strengthen the PBGC. However, we strongly believe that Congress should enact legislation to enable companies such as Loews to reduce or eliminate their underfunded pensions on a more timely basis, by allowing for greater deductions and eliminating penalties.

Loews is a substantial corporation with assets of over 45 billion dollars and a net worth of over 6 billion dollars. Yet, to our embarrassment, Loews appears each year on the PBGC list of the fifty corporations with the largest underfunding of pension plans, colloquially know as the "iffy fifty."

Loews appearance on this list is caused by the underfunding (approximately 140 million dollars using PBGC calculations) of a collectively bargained hourly pension plan of its wholly owned subsidiary, Lorillard, Inc. Over the past few years Lorillard has contributed the *maximum* amount it could to the Lorillard hourly pension plan on a deductible basis, not subject to excise tax penalties.

In addition, in January of 1993 we initiated discussions with the PBGC and with Congress as to ways in which Lorillard might contribute even more. We were advised that even though extra contributions were desirable because they would

strengthen the private pension system, Congress was not likely to permit deductions for such greater contributions since this would affect the deficit.

The problem for Loews under the Code as it now exists comes about because in addition to Lorillard's underfunded collectively bargained hourly pension plan, Lorillard also has a collectively bargained profit sharing plan. The formula to determine the contribution level to the profit sharing plan has remained the same since 1970 with one negotiated reduction in 1986.

Deductions for combined contributions to pension and profit sharing plans are limited under Code Section 404(a)(7) to 25% of total aggregate compensation. The fact that contributions in excess of the 25% limitation may be carried forward for possible deduction in future years is not at all helpful in a downsizing industry with a high proportion of retirees and older workers.

Contributions in excess of the deductible limits are also subject to a 10% excise tax penalty under Code Section 4972. Section 105 of the Bill does offer some relief from excise tax penalties for contributions to 401(k) plans that exceed the 25% limit to a maximum of 6% of compensation. This would not solve Loews problem since the Bill does not provide for any relief where profit sharing plans are involved. Furthermore, the limit of 6% of compensation would be inadequate in our case.

The Bill, while intended to increase minimum funding of substantially underfunded pension plans, will not affect the Lorillard contribution level. Our actuaries project that Lorillard's expected voluntary contribution level (up to the 25% limitation) will for the foreseeable future be higher than the increased minimum funding level proposed under the Bill.

The Bill also provides that for certain underfunded plans the PBGC variable insurance premium cap of $53 per participant will be phased out and the variable insurance underfunding formula of $9 per $1,000 will be applied without the cap. At first blush it seems reasonable to charge higher premiums to plans with the greatest underfunding on the assumption that this is where the greatest risk lies. But an increase in PBGC premiums for the Lorillard hourly pension plan of more than one million dollars each year is not reasonable—and is manifestly unreasonable where:

1. the 25% of compensation limitation on deductions and excise tax penalties has prevented Lorillard from further funding the pension plan;
2. Lorillard has offered to contribute more and has petitioned the PBGC and Congress to remove the limitations;
3. Lorillard's income has been well in excess of the underfunding each year for many years; and
4. The Loews controlled group, which is statutorily liable under Section 4062 of ERISA for the underfunding, has a net worth which is over 40 times the underfunding.

PROPOSED SOLUTIONS AND SUMMARY

The deductibility and excise tax problems exist under current law, but would not be cured by the Bill. The PBGC premium has been raised by the Bill from a tolerable level to an unconscionable level. We respectfully propose the following solutions.

DEDUCTIBILITY LIMITATIONS

We would further fund the Lorillard hourly pension plan if we were able to get statutory relief from the deductibility and penalty limitations. We understand that the Treasury Department has costed out the elimination of the 25% of compensation limit on combined plans and has indicated this would be very costly.

Therefore, we propose that 25% of compensation limit be liberalized (rather than eliminated) by granting an exception for:

(i) combined plans both of which are collectively bargained;
(ii) combined plans covering more than 100 (or ?) employees;
(iii) combined plans where pension plan component is more than $50,000,000 (or ?) underfunded;
(iv) combined plans where the pension plan component is more than 25% (or ?) underfunded; or
(v) any combination of the above.

Different costs would attach to each of these, but the combinations could substantially reduce such cost. In the alternative, we would propose a one or two year window of relief from the 25% of compensation limitation.

EXCISE TAXES

If such relief provisions are enacted for deduction limitations, then relief will obviously not be necessary for excise tax penalties.

If such deduction relief provisions are not enacted, then relief from excise tax penalties should be provided by incorporating in the Bill a provision imposing the excise tax on nondeductible contributions only when one (or a combination) of the items enumerated above in Roman numerals is not present. Such excise tax relief, if included in the Bill, would not create more than a de minimus revenue loss since the excise tax provision as it currently operates must apply very infrequently and only in cases of unintentional over-contributions. It is unlikely that a taxpayer would purposefully incur a 10% nondeductible penalty in order to make a nondeductible contribution.

PBGC PREMIUMS

If relief is not granted from the existing deductibility and/or excise tax limitations, the proposed increase in PBGC premiums under the Bill should be reconsidered. Companies should not be penalized now because Congress has limited their past and present contributions to pension plans.

Whether or not relief from the deductibility and/or excise tax limitations is granted, the proposed increase in premiums might nevertheless be amended to reflect real risk to the PBGC, rather than an oversimplified test based on underfunding alone. For example, a company or a controlled group with large income and large net worth which poses a de minimus risk to the PBGC should not be subject to the increased premiums. We understand that a subjective standard is undesirable, but such a test could be based on company bond ratings.

In the alternative, Congress might provide a mechanism for the employer to pledge Treasury Bills or other securities and to recalculate the variable rate premium of $9 per $1,000 of underfunding, based on the underfunding as reduced by the security.

SUMMARY

Lorillard has been faced with the equivalent of a "catch 22." If it adequately funds its pension plan it is penalized in the form of nondeductibility and excise tax penalties—if it funds its pension plan to the maximum extent it can while still avoiding these penalties, it is then penalized by excessive insurance premiums for the risk involved and by adverse publicity on the "iffy fifty" list.

Trying to strengthen the private retirement system without affecting the deficit is a quandary which should not be resolved by the expedient of increasing PBGC premiums on plans whose underfunding has been mandated by the limitations of the Code. I am confident that Congress will provide appropriate relief in situations such as ours where equity clearly requires relief.

STATEMENT OF THE NATIONAL EMPLOYEE BENEFITS INSTITUTE

The National Employee Benefits Institute ("NEBI") represents Fortune 1,000-sized employers with respect to their employee benefit plans. Most NEBI members sponsor at least one defined benefit pension plan for the benefit of their employees. In addition, most of the defined benefit plans sponsored by NEBI members are well-funded.

NEBI members support the interest of the Senate Finance Committee in strengthening the Pension Benefit Guaranty Corporation ("PBGC") termination insurance for single-employer plans. NEBI members also believe that Congress should enact legislation which improves the funding of underfunded defined benefit plans and insures that the PBGC will be able to pay guaranteed benefits.

GENERAL COMMENTS ON S. 1780

Although NEBI supports the efforts of the Committee to strengthen the PBGC termination insurance system, NEBI believes that pension legislation should not be enacted without addressing the impact of the legislation on national retirement policy. National retirement policy should encourage employers to sponsor plans which provide retirement income to employees. Certain provisions of S. 1780, however, may encourage responsible employers to terminate their defined benefit plans and discourage the formation of new defined benefit plans. This would result in a continuing decrease in worker's retirement income security. Also, the PBGC termination insurance system would be threatened due to an erosion of the PBGC pre-

mium base. Members of the Committee should recognize that continuous changes in pension law without regard to the overall effect on the retirement income security of employees must stop.

The Committee should also note that this legislation does not address issues raised with respect to the significant underfunding of pension plans sponsored by federal and state governments. The real problem is twofold: (1) the private pension plan system lacks encouragement, and (2) regulations applicable to pension plans, while designed to seek out potential abuses of any kind, nature or degree, have created an over-regulated system.

SPECIFIC COMMENTS ON S. 1780

NEBI respectfully submits the following specific comments with respect to S. 1780:

1. *The PBGC Should Not Guarantee Increased Benefits Unless Appropriate Funding Targets Have Been Satisfied By Underfunded Plans.* Current law does not discourage employers with underfunded pension plans from increasing pension benefits provided by these pension plans. In fact, unions and employers routinely negotiate increased pension benefits with reliance on a PBGC guarantee of those benefits. S. 1780 allows underfunded plans to continue to adopt benefit increases which are guaranteed by the PBGC, although more rapid funding of the benefit increases is required.

NEBI proposes that benefit increases adopted subsequent to the enactment of reform should not be guaranteed until an appropriate funding target has been satisfied by an underfunded plan. A phase-in of the PBGC guarantee in relation to a plan's minimum funding schedule would be appropriate. This would eliminate the financing of such promises made by some employers at the expense of all other employers.

In addition, NEBI proposes that lump-sum payments from underfunded plans be determined using either a plan's funding assumptions or market interest rates, whichever yields the lowest lump-sum amount. Sponsors of plans which fail to satisfy funding targets should not be permitted to determine lump sums based on subsidized interest assumptions. (It may be appropriate for plans that are not grossly underfunded and targeted by this legislation to use subsidized rates.) The use of individual interest assumptions can increase a plan's unfunded current liabilities and place PBGC at greater risk.

2. *Section 415(e) of the Internal Revenue Code Should Be Repealed.* NEBI proposes that S. 1780 address another issue related to pension plans: repeal of Internal Revenue Code ("Code") section 415(e).

Simplification of rules regarding defined benefit plans are necessary to stop the exodus of employers from defined benefit plans and to maintain employees' retirement income security. The Administration has indicated an interest in simplification in its discussion of S. 1780. A simplification measure which can be enacted without significant revenue loss would be the repeal of Code section 415(e).

Code section 415(e) limits an employer's deduction for contributions to a combination of pension and defined contribution plans sponsored by an employer. Administration of Code section 415(e) is burdensome. In addition, numerous limitations in the Code which apply to defined benefit plans already significantly restrict benefits before the application of Code section 415(e). These limitations include: (1) recently enacted legislation which limits to $150,000 the annual compensation that can be considered under qualified plans, (2) complicated and extensive nondiscrimination rules, and (3) individual Code section 415 limits on contributions and benefits to qualified plans. Therefore, Code section 415(e) imposes unnecessary administrative burdens on employers without meaningful results.

Another reason to repeal Code section 415(e) is that it greatly impacts on young employees. NEBI has previously demonstrated to members of this Committee the harmful impact of the new $150,000 compensation limit, enacted as part of the Budget Reconciliation Act of 1993, on the participation in 401(k) plans by young employees and those earning just over the highly compensated employee limit. NEBI believes that Congress should consider raising the annual compensation cap because of its harmful effects.

3. *S. 1780 Should Not Further Decrease Code Section 415 Limit.* S. 1780 reduces the limits imposed by Code section 415, 402(g) and 408(k) by providing that the cost of living adjustments to these limits will be made in specific increments, rounding down to the next lowest multiple of the increment ($5,000 for 415 limits and $500 for pretax elective contributions). The purpose and effect of the proposal is to raise revenue by delaying cost of living adjustments. Delaying adjustment to the limits further erodes the retirement income security of employees. Instead, legislation

should be furthered that focuses on simplification and does not penalize employees for the primary purpose of raising revenue.

NEBI supports legislation passed by the House and transmitted to the Senate Finance Committee, entitled the "Tax Simplification and Technical Corrections Act of 1993" (H.R. 3419) which would round the cost of living increases to the nearest $ 1,000 for 415 limits and nearest $ 100 for elective pretax contributions. In addition, if cost of living adjustments are to be simplified, the bill should include the provisions of H.R. 3419 which base the cost of living adjustments on the applicable index as of the close of the calendar quarter ending September 30 of the preceding year—so that adjusted dollar limits are published prior to January 1 of each year.

4. *An Employer's Ability to Satisfy Complex Nondiscrimination Requirements Through the Use of Cross Testing Should Not Be Eliminated.* The Internal Revenue Service, in proposed regulations, incorporated the use of cross-testing under the Tax Reform Act of 1986. These regulations were finalized in 1993. Many large employers have and continue to rely on cross testing to satisfy complex nondiscrimination requirements which may apply to their qualified plans.

Cross testing applies when a defined contribution plan is tested for nondiscrimination on the basis of the benefits provided. It can be used when a defined benefit plan and a defined contribution plan are aggregated and tested jointly on a benefits basis. The Administration proposes in S. 1780 to eliminate cross testing because the Treasury Department believes that cross testing allows employers to make allocations to defined contribution plans which unreasonably favor highly compensated employees.

NEBI supports legislation which prevents abuse in defined contribution plans that favor primarily highly paid employees. However, NEBI does not support the complete elimination of cross testing, which will unreasonably harm many employees of responsible employers. NEBI, therefore, encourages the Committee to support proposals which narrowly limit the use of cross testing to prevent abuse.

CONCLUSION

NEBI is pleased to present its statements on S. 1780, the Retirement Protection Act of 1993. NEBI hopes the Committee can refocus the legislation on the funding of pension plans, thereby reducing the PBGC's liability and not attempt simply to raise revenue through provisions which harm the retirement income security of our nation's workers.

This statement is respectfully submitted by Steven D. Huff, Executive Director of NEBI.

**STATEMENT BY THE PRINCIPAL FINANCIAL GROUP
TO
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
THE RETIREMENT PROTECTION ACT OF 1993
S. 1780
June 15, 1994**

THE ISSUE

The PBGC single-employer fund currently has a large funding shortfall. Despite increases in PBGC premium rates and legislation intended to limit PBGC's liability, the PBGC's financial condition continues to worsen. The Retirement Protection Act of 1993 (S. 1780) aims to improve the defined benefit plan system and protect the benefits of plan participants by strengthening the funding rules for underfunded plans; increasing premiums for those plans that pose the greatest risk; enhancing PBGC's compliance authority; and broadening participant disclosure requirements.

BACKGROUND

Congress established the PBGC in 1974 under ERISA to insure, to a large degree, payments made under most defined benefit pension plans. Congress established two programs—the multi-employer program (which currently operates at a surplus) and the single-employer program (which currently operates at a loss). Both programs were to be entirely funded by the premiums paid by plans the PBGC insures. The minimum annual premium has increased from $1 in 1974 to the current $19 per participant, with a possible additional premium of $53 per participant for underfunded plans ($72 maximum premium).

PBGC's Current Status

- The PBGC's deficit for the single-employer fund was nearly $2.9 billion in 1993.
- Total underfunding in single-employer plans insured by the PBGC was $53 billion at the end of 1992.
- The PBGC forecasts that, depending on the level of future losses, its deficit could range between $1.9 billion and $13.8 billion by the end of fiscal year 2003, due to minimal funding of a minority of defined benefit plans and increased benefits due to plan terminations or plant shut downs.
- Potential liability rests primarily with certain industries or specific plan types.
  - $38 billion underfunding is concentrated in the steel, airline, tire manufacturing and automobile industries ($14 billion of this in financially troubled companies).
  - Troubled plans are typically larger ones with "dollars times years of service" benefit formulas (e.g. a monthly benefit of $10 for each year of service with the employer).
- PBGC has sufficient revenues and assets on hand to meet its obligations for many years.

THE PRINCIPAL POSITION

The Principal believes a strong PBGC is essential to the national pension system. It must remain a safety net to insure the benefits of defined benefit plan participants. We applaud the portions of the proposal which help protect the retirement security of millions of workers and retirees. We agree that while the PBGC is not in immediate danger, changes should be made now — while the problem is still manageable. For that reason, we believe the proposed legislation is a step in the right direction. However, we are concerned about some provisions which seem to be unrelated to strengthening the PBGC. We offer the following additional comments and concerns:

1. Proposals We Strongly Support

- Strengthen funding rules for underfunded pension plans to require faster funding;
- Prohibit employers from increasing benefits in underfunded plans during bankruptcy proceedings;
- Phase out the current cap on PBGC's variable rate premium over three years;
- Eliminate quarterly premium contributions for fully funded plans;
- Eliminate the 10% excise tax on certain nondeductible contributions;
- Enable PBGC to seek judicial relief short of plan termination when corporate transactions threaten pension funding (e.g., seeking a court order to require a departing controlled group member to remain responsible for pension underfunding for a specific period of time or to post security for part of the pension liabilities);
- Enable plans to file claims against a liquidating sponsor or controlled group member without plan termination;
- Enable PBGC to enforce minimum funding requirements; and
- Improve PBGC's current authority to file liens for missed contributions.

In particular, The Principal supports the goal of strengthening the PBGC's financial condition through tougher funding requirements for underfunded plans. We feel the proposal will, in general, achieve this goal. We are particularly pleased that the proposed funding rule changes will not affect fully funded plans. We are also pleased that the funding rule changes will not affect plans with less than 100 lives.

The Principal also supports prohibiting employers from increasing benefits in underfunded plans during bankruptcy proceedings. We believe the proposal should also prohibit certain plan amendments which do not directly increase a plan's benefit formula, but do substantially increase a participant's benefit. These would include plant shut down benefits, changes to a plan's early retirement provisions, or lump sum benefit options. Each of these provisions could increase a participant's retirement benefit and thus increase the potential liability of the PBGC.

The Principal supports the proposal to increase premiums for those plans most at risk. According to the PBGC, plans at the variable rate cap account for 80 percent of all underfunding yet account for only 25 percent of PBGC's premium revenue. Phasing out the cap on the variable rate premium will provide strong financial incentives for underfunded plan sponsors to improve their funding levels. We strongly support the recommendation to retain (or lower) the flat premium rate of $19. Plan sponsors of fully funded plans cannot—and should not be asked to—bear repeated premium increases. Each time the base rate premium has increased, more sponsors of fully funded plans have terminated their plans, resulting in less pension coverage nationwide and further pressure on the PBGC. Requiring plan sponsors of underfunded plans to take more responsibility for their underfunding is highly appropriate.

2. Proposals Requiring Clarification

- Transition rules to ease the impact of the new funding rules;
- Establish new reporting requirements to provide information on seriously underfunded plans to PBGC;
- Protect the interests of participants who cannot be located upon plan termination by requiring the plan sponsor to transfer sufficient assets to pay the participants' benefits to the PBGC;
- Specify uniform assumptions for calculating a plan's minimum funding contribution;
- Specify assumptions to be used to calculate participants' lump sum benefit payments; and
- Round dollar limits for cost of living adjustments.

The Principal questions whether the new funding rules should be phased in over a transition period. This sort of transition rule is a great example of why maintaining a pension plan is so complicated. We believe it is appropriate to consider applying the funding rules in 1995 (without a transition period) and then let plan sponsors apply for a waiver to the IRS of a portion of the funding requirement under the waiver rules as currently in effect.

We support the idea of additional PBGC reporting requirements but believe there will likely be noncompliance with the new rules. Employers, particularly those owned by foreign companies, may not know all the members of the controlled group and may not know if a reportable event has occurred. Also, a single service provider may not provide plan services (actuarial valuation, recordkeeping, etc.) to the entire controlled group. Therefore, the service provider will not be able to monitor the plans and determine if a reportable event has occurred. This will likely result in unintentional noncompliance by some plans.

The proposal to specify the assumptions used to calculate the plan's minimum funding contribution concerns us. Enrolled actuaries curently have an obligation to choose reasonable assumptions when calculationg the minimum funding level. As a result, we question whether it is necessary to place additional restrictions on the selection of actuarial assumptions.

We believe the proposals regarding lump sum distributions and rounding cost of living adjustments are separate issues. Neither proposal addresses the issue of improving plan funding. We are particularly concerned about the single sum distribution proposal since it impacts all defined benefit plans and requires plan amendments. Before we can support this item we need more information about using the 30 Year Treasury Rate. Is it averaged over time? Can the rate on the first day of the plan year be used? As for the proposal to round the cost of living adjustments, we question whether a provision designed to hold down the tax expenditure for qualified plans should be included in a PBGC funding proposal.

3. **Proposals We Cannot Support**

- Add a plan solvency rule requiring underfunded plans to have enough liquid assets to pay at least 3 years of benefits;

  We have several reservations about the proposal to require a plan to hold cash equal to three years' worth of payments (based on the last 12 months). First, a solvency rule based on payments for the prior 12 months will not ensure adequate assets to pay future benefits. Instead, any solvency rule should be based on the plan's expected benefit payments. Second, we question whether Congress should dictate to plan sponsors how to invest plan assets. The solvency rule may cause plan sponsors to invest more assets in low-yielding instruments than necessary, resulting in reduced returns and higher contribution requirements. Instead, we believe the DOL can ensure that plan sponsors and trustees have sufficient assets on hand to pay benefits through enforcement of ERISA's fiduciary prudent person rule. If some modification is really needed, we suggest guidelines requiring plan sponsors to take into account expected benefit payments when establishing asset allocations.

- Broaden disclosure of information for participants and retirees on their plan's underfunding and the limits of PBGC's guarantee through an annual plain-language explanation of their plan's funding status; and

  The Principal supports the goal of educating participants about their retirement benefits and preparing them to make better financial decisions. We believe each plan sponsor should provide participants with information about their plan benefits and explanations of the PBGC's guarantee of those benefits. However, we question whether increasing the disclosure requirements to participants about the plan's funding status will improve the level of plan funding. Since participants generally have no say about a plan's funding level, it is hard to see that this will do much to solve the core problem of plan underfunding.

- Eliminate cross-testing of defined contribution plans on a benefits basis.

  We support the concept of cross-testing defined contribution plans on a benefits basis and feel it is an important plan design option. It has opened up some new plan design options and is bringing more employers (and members) into the private pension system. While some plan sponsors may use this to skew benefits in favor of the highly paid employees, the majority use it to provide non-discriminatory benefits to all their employees. If change is needed, we favor modification of the current rules rather than outright elimination. In addition, we strongly oppose the provision that would apply these changes retroactively to plans established after September 30, 1993. Any modifications made to the current rules should apply prospectively for all plans.

SUMMARY

The Principal believes a strong PBGC is essential to the national pension system and must remain a safety net to insure the benefits of plan participants. In general, we support the proposal's efforts to better coordinate the methods of determining minimum funding requirements and actual plan termination liability in order to reduce the amount of underfunding at plan termination. We also support efforts to place more responsibility on employers and employees for establishing affordable benefits. However, we do have reservations about several of the proposed changes and hope that Congress will consider carefully whether the changes will indeed achieve the goal of improving the financial status of the PBGC.

Information About The Principal Financial Group

The Principal Financial Group is a family of insurance and financial services with assets of more than $44 billion. Its largest member company, Principal Mutual Life Insurance Company, is currently the fourth largest life insurance company in the nation ranked by premium income.

The Principal Financial Group serves 703,000 individual policy holders, more than 74,000 group employer clients, 33,000 pension contractholders and 62,600 mutual fund shareholder accounts. In all, 7.6 million customers (businesses, individuals, and their dependents) rely on the companies of The Principal Financial Group for their financial services needs.

For More Information

Questions or comments may be directed to any of the following employees of The Principal:

Stuart Brahs, Vice President — Federal Government Relations: (202) 682-1280

Larry Zimpleman, Vice President — Pension Services: (515) 247-5752

Jack Stewart, Assistant Director — Pension Services: (515) 247-6389

Prepared Statement of the U.S. Chamber of Commerce

(BY PETER M. KELLY [1])

The U.S. Chamber of Commerce Federation of 215,000 businesses, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 69 American Chambers of Commerce abroad welcomes this opportunity to present its views on legislation concerning the termination insurance program administered by the Pension Benefit Guaranty Corporation (PBGC).

Background

Since enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the Chamber has been actively involved in legislative debates over amending the termination insurance system. For example, Chamber committees played a significant role in the evaluation and improvement of proposals leading to enactment of single-employer system reforms in 1986, 1987, and 1989. Since that time, we have maintained a continual dialogue with members of this Committee on related issues. Chamber policy with respect to the latest proposals to amend the termination insurance program may be helpful to you in your deliberations.

The Defined-Benefit Pension System

The chart in Attachment A illustrates that the trend away from defined-benefit plans dates from the enactment of ERISA. Structural reform of the termination insurance system temporarily slowed or reversed this trend in 1985 and 1986. However, the combined impact of premium tax increases (from $1 to $19 per participant at the most basic level, as shown in Attachment B) and excise taxes imposed in the late 1 980s has drastically accelerated the decline in the net rate of formation of new defined-benefit plans (i.e., new plans established minus plans terminated). Since 1987, the Internal Revenue Service has issued determination letters with respect to 40,982 newly established defined-benefit plans and 80,323 letters with respect to terminating plans, for a negative net growth of 39,341 plans. In each of the five most recent years for which data are available, "growth" has been negative.

While an economic downturn played a critical role for a time, the trend to slower plan formation has continued into a period of economic recovery. One reason is that job growth in the post-ERISA period has been in nonunion service jobs not traditionally associated with defined-benefit plans. In addition, the baby-boom generation has not yet reached the age when the monetary advantages of defined-benefit plans

---

[1] Peter M. Kelly is a partner with the law firm of Murphy, Smith & Polk P.C. in Chicago. He chairs the Qualified Plan Subcommittee of the Chamber's Health and Employee Benefits Committee. Mr Kelly has practiced in the employee benefits field since 1973.

exceed the perceived value of the flexibility or growth potential of defined-contribution plans such as 401(k) plans.

The demographic and business trends which have contributed to the defined-benefit decline eventually will be reversed. As service workers and their employers become more institutionalized, and as the baby boomers continue to age without adequate savings, pressure for defined-benefit plans will increase. The Chamber would like to be reassured that restrictive rules and burdensome PBGC premiums will not prevent such plans from achieving a predominant role in building new retirement savings. Defined-benefit plans will only be adopted if the applicable rules are made more rational and if the cost of termination insurance is restrained. We believe that the PBGC recognized a risk to the whole system when it expressed opposition to further increases in the flat-rate premium paid by the most well-funded plans.

The defined-benefit plan should be preserved as a viable plan design option, and we urge you to approach your deliberations on PBGC legislative and regulatory initiatives from this perspective.

The Retirement Protection Act

PBGC Premiums—The Chamber's primary objective with respect to single-employer plans is to foster the voluntary sponsorship of well-funded retirement plans, including defined-benefit plans. Our member companies have been alarmed by the history of ever-increasing PBGC premiums (Attachment B). The Chamber will oppose legislation that further burdens sponsors of well-funded plans. We support the decision by the drafters of S. 1780 to hold the line on flat-rate premiums. Indeed, we suggest that any change made should be a reduction in such premiums to encourage the formation of healthy defined-benefit plans.

The Chamber certainly can see the rationale for a proposal to increase the premium pressure on sponsors of poorly-funded plans. However, our members have expressed to the PBGC their concern about the way that S. 1780 will change the methods used to determine which plans are subject to risk-related premiums. The Qualified Plan Subcommittee, a Chamber policy group that I chair, has requested further information regarding the projected impact of these changes. Our fear is that some employers who legitimately believe they are maintaining sound, well-funded plans may be swept into the category of plans on which higher, risk-related premiums are imposed. We encourage the Committee not to conclude its study of S. 1780 until reliable information concerning the impact of these provisions is available.

Funding Changes—S. 1780 proposes several funding changes. Varied and complex in mechanism, they have a stated goal of permitting or requiring faster funding by sponsors of underfunded plans. Viewed in terms of their impact, the proposed changes are designed to make it more difficult for sponsors of troubled plans to transfer their obligations to the termination insurance system.

We respond positively to most of the funding changes, including the elimination of double counting of actuarial gains and losses in determining an employer's Deficit Reduction Contribution, the general concept of a solvency contribution, accelerated recognition of bargained benefit increases, and the prohibition of benefit increases in bankruptcy. However, we approach more cautiously the proposals to limit actuarial assumptions more strictly, since the precise impact of these restrictions and of the new solvency contribution requirement is not yet clear. There is some concern that the new restrictions will subject many more plan sponsors to the Deficit Reduction Contribution requirements and risk-related premiums.

The proposal to eliminate quarterly contributions for well-funded plans is welcome. Aside from this change, S. 1780 offers little assistance to sponsors of healthy plans. A strong argument can be advanced that plan sponsors should have greater freedom to increase deductible contributions during years when they experience strong financial results, even at the risk of modest overfunding over short periods of time. We believe that a relaxation of the funding limitation to permit additional contributions by sponsors of healthy plans would be good public policy, contributing to savings and investment and permitting such plans to remain healthy in all economic cycles.

Enforcement—Some of the proposed means to enhance PBGC's enforcement capabilities, such as a stronger Reportable Event process, seem reasonable. However, there appears to be entirely too much emphasis on litigation and preemptive intervention in business transactions. The legislation should include standards and safeguards to prevent overzealous administration of the termination insurance program.

Cross-testing and Age-weighting—We oppose the proposal to eliminate cross-testing of age- and service-weighted plans, which would be quite harmful to Chamber members, especially small businesses, which need a weighted-plan option that allows them to make up for previous years when company revenues could not sus-

tain a retirement plan. We question whether S. 1780 is the proper vehicle for any restriction of the use of these techniques for defined-contribution plans, which are not even covered by termination insurance.

Other Legislation

Despite the history of increases in PBGC premiums, the termination insurance system is still menaced by a looming PBGC deficit. In assessing the causes of this state of affairs and arguing against further premium increases, PBGC has laid much of the blame on benefit increases in underfunded plans. A solution offered by Representative Pickle in the House (H.R. 298) was designed to strengthen provisions of ERISA and the Internal Revenue Code which restrict benefit-increase amendments and require responsible funding.

We share Representative Pickle's concern that the termination insurance system for both single-employer and multiemployer plans fails to satisfy basic casualty insurance underwriting standards. Sponsors and joint boards of trustees with the authority to amend defined-benefit pension plans may exercise that authority to increase benefits even at a time when such plans are seriously underfunded. Although existing law curbs the ability of single-employer sponsors to adopt such benefit-increase amendments, no such restriction applies to multiemployer plans. We do have some concerns with the precise funding standard that would be established under Representative Pickle's legislation, but are confident that with technical amendments these proposals would provide material benefits by restraining system-wide premium increases.

H.R. 298 would amend the restrictions on underfunded plan benefit increase amendments contained in Code Section 401(1)(29) and ERISA Section 307 and the funding rules of Code Section 412 as follows:

1. The restrictions would be extended to cover multiemployer plans. Currently, only single employer plans are subject to such restrictions.
2. The restrictions would be made applicable to more plans. The rules currently apply only to plans which fail to satisfy a 60 percent funding standard. The manner in which the funded status of a plan is calculated would change and the amendment restriction would apply to plans that are less than 90 percent funded.
3. A provision which currently exempts $10 million of underfunding from the security requirements would be replaced by a provision exempting $1 million in underfunding from the stricter 90 percent standard.
4. The funding rules applicable to underfunded single employer plans would be strengthened for plans that are less than 100 percent funded.

The Chamber believes strongly that trustees of seriously underfunded multiemployer plans should be prevented from increasing plan benefits.[2] This will put an end to an abusive pattern of conduct which has been followed by some plans.

The withdrawal liability rules and the funding standards force contributing employers to underwrite a multiemployer plan's benefit payment obligations, even if the employers have conscientiously made all contractually-required contributions. Contributing employers currently have no meaningful protection against unreasonable benefit amendments.

Imposing benefit amendment restrictions would not be too great a burden for the large majority of multiemployer plans that are well-funded. However, doing so will restrain those unscrupulous multiemployer plan trustees who have demonstrated a willingness to aggravate the financial weakness of underfunded plans in reliance upon windfall withdrawal liability recoveries.

In single-employer plans, prudent funding avoids the dangers to employers, shareholders, employees, and the termination insurance system which are implicit in the maintenance of an underfunded plan. In addition, by complete funding of benefit entitlements, a sponsoring employer fulfills its pension promises. If such plans reach the end of their life cycles, the expectations of all parties may be satisfied after a standard termination of the plan.

Actuarial science is imprecise. It is unlikely that an employer's contributions when combined with fund experience will actually hit the precise funding target. However, it is reasonable to require plan sponsors to show restraint in promising

---

[2] There is one technical problem in the proposal as applied to multiemployer plans. The revision to EAISA Section 307 imposes a security requirement on contributing employers who may be unaware of and opposed to a benefit increase. Applying a criminal or civil sanction or costs on such employers seems unreasonable. This will provide unscrupulous trustees with an additional lever which will make it easier to impose unfunded benefit increases. In order to prevent this abuse, the following new subsection (f) could be added to EAISA Section 307:

(f) No plan sponsor, plan administrator or other person shall adopt or implement an amendment described in (a) which takes effect with respect to any contributing employer without the written consent of such contributing employer.

new benefits at a time when the best available actuarial evidence suggests that existing benefit commitments are underfunded. The failure of ERISA to restrain the creation of new benefits rights under an underfunded plan was a fundamental flaw in the termination insurance program.

The approach taken by H.R. 298 would reduce the pressure on the termination insurance system. Employers who follow prudent funding practices may face little risk of surprise liabilities under their own plans, but they are collectively serving as an involuntary surety of those employers who operate underfunded plans in an irresponsible fashion. This situation violates fundamental insurance principles since sponsors of well-funded plans do not have the underwriting discretion that protects a commercial surety which writes performance or payment bonds. The proposed changes in the protections of Code Section 401(a)(29) and ERISA Section 307 should improve the quality of this underwriting risk.

While a 90 percent funding requirement strikes us as excessive, some increase in the current 60 percent standard probably is appropriate. We also have some reservations concerning the severity of the penalty for violations of a relatively new and very complex security requirement. However, this proposal deserves the Committee's attention, especially because it addresses a fundamental flaw in the current PBGC insurance system.

Bankruptcy Issues

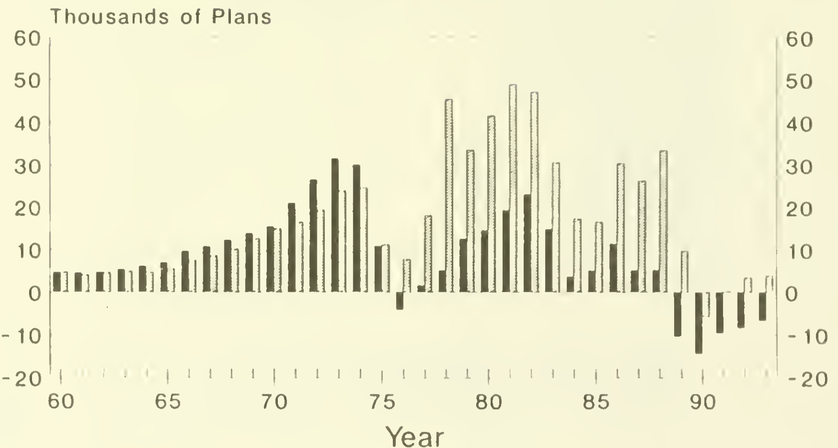
Although we have generally been supportive of past efforts of the PBGC to amend bankruptcy laws to improve its status in bankruptcy, we want to be sure that extraordinary liens and other priorities favoring the PBGC are geared to restraining the growth of the PBGC's exposure. This principle will preserve the settled expectations of other creditors while protecting the PBGC.

We cannot stress strongly enough the importance of viewing any bankruptcy amendments in the broader context of bankruptcy reform. In this connection, we encourage the Committee and the PBGC to work closely with the Judiciary Committees of the Senate and the House. One of the most frustrating aspects of the legislative process which led to the enactment of termination insurance system reforms in 1986 was the failure of the PBGC to adequately address the legitimate jurisdictional concerns of the Senate Judiciary Committee in fashioning its legislative proposals.

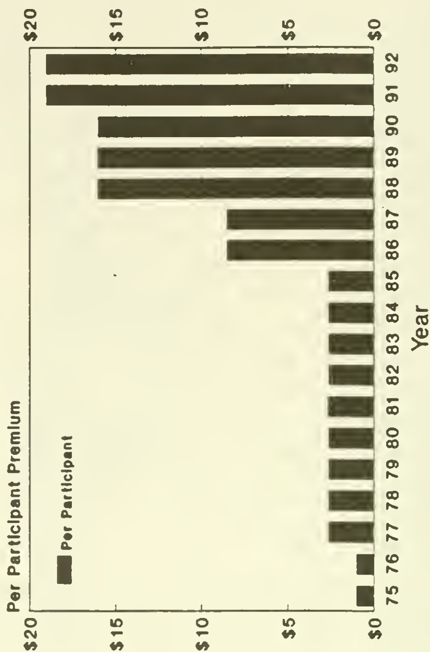
Conclusion

The Chamber supports the goals of the Retirement Protection Act, and believes that it is moving in the right direction. However, the bill as currently written raises significant concerns. We believe that the termination insurance program and all its participants would benefit from further deliberation and refinement. We look forward to working together to preserve and strengthen the defined-benefit pension system.

ATTACHMENT A



ATTACHMENT B



STATEMENT OF THE U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee: Thank you for inviting me to submit this statement for the record pertaining to the administration's proposed pension reform legislation, S. 1780, the Retirement Protection Act of 1993. The majority of pension plans insured by the Pension Benefit Guaranty Corporation (PBGC) are well funded. However, a significant minority are underfunded, and the level of underfunding in these plans has been growing in recent years. This growth increases PBGC's exposure (the size of its potential claims).

Because of PBGC's large and growing deficit,[1] the size of the exposure it faced from underfunded plans, and its financial system and internal control weaknesses, we placed PBGC on GAO's list of "high-risk" government programs in 1990. It remains there today. We believe PBGC will continue to be at risk until its deficit is reduced and the funding in underfunded plans is significantly improved, and we believe stronger funding requirements are needed for such an improvement to occur.

At the request of the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, we have been studying funding issues for underfunded defined benefit pension plans and will be issuing a report to him in the near future.[2] Our study looks at the effectiveness of current funding rules and at the impact on plan funding of the administration's proposal. This statement is based on our results to date.

I would like to make three main points. First, current rules designed to ensure that sponsors of underfunded plans make additional contributions to better fund their plans are not working well. Second, S. 1780 should lead to substantial improvements over current law. And third, S. 1780 could and should be strengthened.

HISTORY OF PENSION PLAN FUNDING REGULATIONS

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), only minimal funding rules existed. As a result, participants lost promised benefits if their underfunded plans terminated. Among other provisions, ERISA established firm minimum funding rules and established PBGC to insure the pension benefits of participants in most defined benefit plans. The ERISA funding rules worked as intended for many plans, but by the mid-1980s it became apparent that they did not work well for some plans.

To further protect PBGC and bolster funding levels in underfunded plans, the Congress enacted the Pension Protection Act (PPA), a part of the Omnibus Budget Reconciliation Act of 1987. Among the act's provisions was an additional funding requirement for large (101 or more participants) underfunded plans. Sponsors of these underfunded plans not only had to make the contribution dictated by ERISA's minimum funding rules (specified in sec. 412(b) of the Internal Revenue Code (IRC), they had to determine if they were required to make additional contributions (specified in sec. 412(l) of the IRC), which are contingent upon both the level of plan underfunding and when it was incurred.

Plans subject to the additional funding requirement first determine their deficit reduction contribution (DRC), the additional contribution before any adjustments are made.[3] The DRC is reduced by subtracting selected components of the plan's minimum required contribution under ERISA. This reduction amount is called an offset.[4] [5]

The expectation was that this additional funding requirement would help to accelerate the movement of underfunded plans toward full funding. The Congress's expectation has not been realized. PBGC reports that underfunding in the single-employer plans it insures increased from $31 billion in 1990 to over $50 billion at the end of 1992. Although this increase is due in part to declining interest rates, the trend is cause for concern.

---

[1] The deficit in PBGC's Single-Employer Program was $2.9 billion on September 30, 1993.

[2] In a defined benefit pension plan, benefits are generally based on a formula that takes into consideration job tenure and/or earnings.

[3] The DRC comprises a payment for the plan's underfunding at the beginning of the 1988 plan year, amortized over 18 years, and a payment for any new underfunding amortized over a shorter period that depends on the ratio of plan assets to plan liabilities (the plan's funding ratio). We estimate that between 2,500 and 3,600 plans were subject to the additional funding provision in 1990.

[4] Components of the offset (for example, the amortization payment to reduce unfunded past service liabilities arising from plan amendments) are listed in sec. 412(l)(1)(A)(ii) of the IRC.

[5] If the plan has an unpredictable contingent event payment (usually caused by a plant shutdown), an additional payment is added to the net amount computed. The net DRC is then tested to ensure that it does not exceed the beginning-of-year underfunding in the plan. Finally, it is reduced for plans with not more than 150 participants.

SHORTCOMINGS IN THE CURRENT LAW

To determine the effectiveness of the Pension Protection Act's additional funding requirement, we randomly selected a sample of 93 plans from the approximately 5,000 large plans that were making variable rate premium payments to PBGC in 1990.[6] Fifty-seven of these 93 plans had unfunded current liabilities and, therefore, were subject to the additional funding requirement. We focused our analysis on three factors that can influence the size of additional contributions—the offset, splitting plan underfunding into old and new components, and interest rates.

We found that the current law offset completely eliminated additional contributions for sponsors of 34 plans in our sample that were subject to the additional funding requirement (60 percent) and reduced them substantially for 16 others (28 percent). Sponsors of only 22 plans in our sample made additional contributions in 1990,[7] and these additional contributions equaled only 2.6 percent of the underfunding in those 22 plans.

This suggests, in our view, that the design of the offset is flawed. Under current law, the offset can be much larger than the DRC because, for most underfunded plans in our sample, the offset contains most of the amortization charges included in the ERISA minimum contribution but few of the counteracting amortization credits. The offset should, at a minimum, include all amortization charges and all amortization credits in the ERISA minimum contribution.

Also, splitting a plan's liability into old and new components reduced both the size of additional contributions and the number of sponsors who would make them. Because this provision is transitional and is designed to phase out, we do not believe it needs to be modified.

Finally, in 1990 plans were not using high interest rates to avoid making additional contributions. Only about 25 percent of the plans in our sample used an interest rate in the top half of the allowable range, and only two plans used the highest permitted rate.

PROPOSED LEGISLATION TO IMPROVE FUNDING

The bill before the Congress, S. 1780, the Retirement Protection Act, addresses the shortcomings in the current law. Our analysis indicates that S. 1780 would increase the number of sponsors of underfunded plans making additional contributions compared with current law and would substantially increase the amount of additional contributions affected sponsors would pay (see table 1).

Table 1.—COMPARATIVE EFFECTS OF ADDITIONAL FUNDING REQUIREMENTS UNDER CURRENT LAW AND S. 1780, BASED ON A SAMPLE OF 93 PLANS IN 1990

	Provision	
	Current Law	S. 1780
Number of plans subject to additional funding requirement	57	65
Total underfunding (all plans)	$201.6 M	$255.6 M
Number of plans receiving additional contributions	22	34
Total underfunding in plans receiving additional contributions	$106.5 M	$221.6 M
Total additional contributions	$2.8 M	$28.0 M
Additional contribution as a percent of underfunding (in plans receiving them)	2.6%	12.6%

Our analysis suggests that the administration's bill, S. 1780, moves in the right direction in addressing the underfunding problem for many underfunded plans. Indeed, most funding provisions in the bill will affect only underfunded plans. Another advantage of the bill is that its funding proposals only modify the structure of current law, so practitioners will not have to learn a new system. Most importantly, the bill corrects the current law offset's design flaw. In our view, the redesign of the offset is the single most important funding provision in the bill and is needed, as is, to maintain the integrity of the proposal.

[6] The variable rate premium, which depends on the per participant level of plan underfunding, is an additional premium paid to PBGC by underfunded plans. The measure of underfunding differs from that used to determine if additional contributions should be made.

[7] Another sponsor should have made additional contributions, but did not because the instructions were misinterpreted.

The bill also contains several other provisions that can increase contributions to underfunded plans. These include a solvency rule, restrictions on actuarial assumptions, an increase in the deficit reduction contribution for many plans, and the immediate recognition of benefit increases.

The solvency rule would require that plans' liquid assets equal at least 3 years' disbursements. Our earlier work on hidden liabilities in pension plans demonstrated that underfunding can increase rapidly in many plans immediately before termination.[8] The solvency rule would provide that a cushion of assets be maintained to protect plan participants and the PBGC. Only one plan in our sample would have received a solvency rule contribution under this provision in 1990.

The restrictions on actuarial assumptions would dictate that plans determine their current liabilities using a specified mortality table and the lower half of the current allowable interest rate range. These restrictions would increase current liabilities for most plans in our sample and would increase the number of plans subject to the additional contribution provision.

The administration's bill would also increase the DRC for plans whose funding ratios exceed 35 percent and would require immediate recognition of all bargained benefit increases, even if part of the increase does not take effect for several years. The first provision would increase additional contributions for most sponsors making them. The second would accelerate funding in negotiated plans, which generally are flat benefit plans,[9] a type of plan particularly susceptible to underfunding. We used our sample of plans to estimate the impact of the administration's bill had it been in effect in 1990. The actuarial assumption restrictions would have increased the number of plans subject to the additional contribution provision from 57 to 65. Sponsors of 34 of these 65 plans (52 percent) would have made additional contributions equal to about 12.6 percent of the plans' underfunding. Sponsors of all plans in our sample with funding ratios of less than 50 percent would make additional contributions, while sponsors of about half the plans with funding ratios between 50 and 80 percent and about 36 percent of those whose plans had funding ratios above 80 percent would make additional contributions.

Further Strengthening of Funding Rules Desirable

Despite the funding improvements that S. 1780 would bring, sponsors of some marginally funded plans would still not make additional contributions. These sponsors may make additional contributions at some point in the future under S. 1780, but we are concerned that some plans may never become fully funded unless they do.

Sponsors of only about 40 percent of the 57 underfunded plans in our sample make additional contributions under current law. The administration's proposal would, we estimate, increase both the number of plans subject to the additional contribution provision and the percentage making additional contributions. Based on our sample, the number of plans subject to the provisions will increase by about 15 percent, and between 50 and 60 percent of this higher number will make additional contributions.[10] With time, this percentage could increase further (because of the elimination of the unfunded old liability component of the DRC, for example).

Nevertheless, sponsors of some plans with relatively low funding ratios will not make additional contributions because their offsets will continue to exceed their DRCs. For example, one plan in our sample, that did not receive additional contributions in 1989 or 1990 and would not receive additional contributions under S. 1780, had a funding ratio that declined from 58 percent in 1988 to 55 percent in 1990. The ERISA minimum contribution did not improve funding in this plan from 1988 to 1990, and we have no reason to believe that this contribution alone will improve the plan's funding in the future. In our opinion, this plan should be receiving additional contributions to bolster its funding.

The most direct way to rectify this problem is to require that sponsors of all plans with funding ratios below a specified threshold, say 80 percent, make an additional contribution to improve their plans' funding. This could be accomplished by capping the offset at a certain percentage of the DRC. This modification would cause sponsors of all plans with funding ratios below 80 percent to make an additional contribution.

---

[8] *Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Program* (GAO/HRD-93-7, Dec. 30, 1992).

[9] Flat benefit plans generally pay a specified dollar amount per year of service.

[10] Sponsors of 52 percent of the underfunded plans in our sample would make additional contributions with the bill's proposed transitional limitations in place. These limitations would restrict the level of additional contributions through the 2001 plan year. Without these restrictions, sponsors of 38 of the 65 underfunded plans (58 percent) would make additional contributions.

In our sample, sponsors of 75 percent of the underfunded plans would make additional contributions if this modification were in effect (see fig. 1). Those that would not make additional contributions have plans that are at least 80 percent funded. Figure 2 shows additional contributions as a percent of underfunding (for plans receiving additional contributions) under current law, the S. 1780 proposal, and an example of a strengthened proposal with the offset cap set at 50 percent of DRC.

While this approach will increase additional contributions by sponsors that might not make them otherwise, it will also reduce federal revenues because these contributions are tax deductible. The lower the level of the cap on the offset, the higher the additional contributions and revenue loss. To address this issue, the Congress would ultimately have to balance the budget's PAYGO (pay-as-you-go) considerations against improved protections for PBGC and participants in underfunded plans.[11]

The administration's bill contains a number of proposals that do not impinge on plan funding. Although we have not evaluated all of these other provisions, on the basis of our previous work, we see value in the provisions that would (1) require notification of participants of their plan's funding status and the limitations of PBGC's guarantee, (2) require disclosure to PBGC of information necessary to determine current liabilities and assets for certain plans, and (3) remove the cap on the variable rate premium.

CONCLUSION

Our work to date suggests that the evidence of funding problems in some plans is sufficiently compelling to support stronger funding requirements for underfunded plans. PBGC calculations show that underfunding in the plans it insures is increasing in spite of provisions in the 1987 Pension Protection Act and is now over $50 billion. Continued and growing underfunding has several negative impacts. It (1) increases PBGC's exposure, (2) puts plan participants at risk of losing benefits not guaranteed by PBGC, (3) may result in premium increases for well-funded plans (to reduce PBGC's losses), and (4) might result in a taxpayer-assisted bailout of PBGC should the agency become unable to meet its benefit obligations. Improving the funding of underfunded plans would benefit each of these groups.

The additional contribution provision of the 1987 Pension Protection Act appears to be having less impact than envisioned on improving funding in underfunded plans. The proposed funding provisions in the administration's Retirement Protection Act, especially the revised offset design, should increase both the number of sponsors of underfunded plans that make additional contributions and the amount of these additional contributions. However, based on our sample, sponsors of about half the plans that are 50 to 80 percent funded will not make additional contributions under the proposed funding rule changes. As a result, we believe the proposed funding provisions need to be strengthened further to ensure that an even greater percentage of underfunded plans' sponsors make additional contributions.

---

[11] Under the Budget Enforcement Act, PAYGO requires that all direct spending and tax legislation enacted during a session of the Congress must be deficit-neutral in the aggregate.

Figure 1: Estimated Percentage of Underfunded Plans Receiving Additional Contributions Under Current Law, S. 1780, and S. 1780 Modified So That All Plans Less Than 80 Percent Funded Receive Additional Contributions

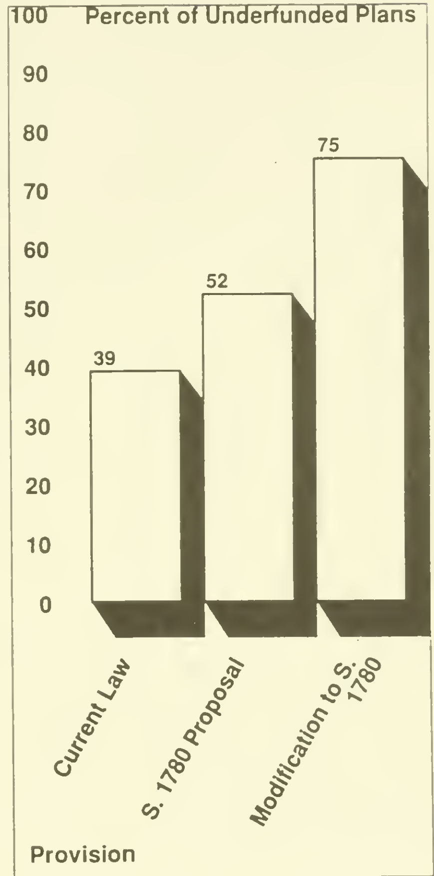
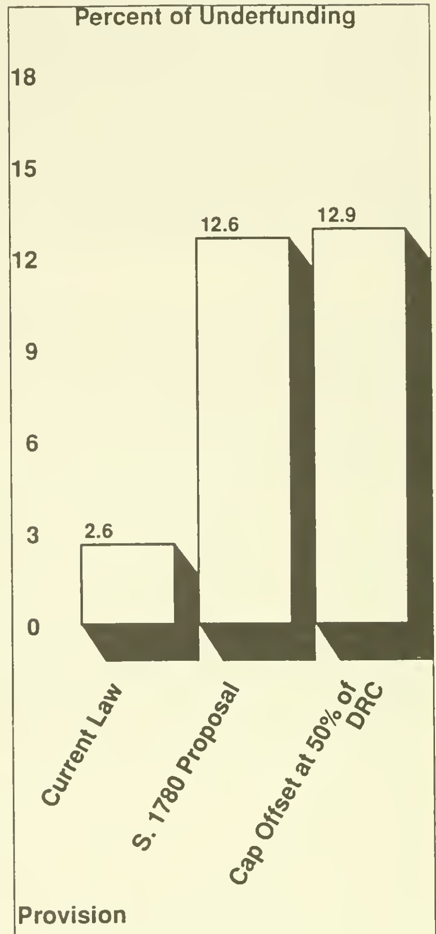


Figure 2: Estimated Additional Contributions as a Percent of Underfunding Under Current Law, S. 1780, and S. 1780 Modified So That the Offset Is Capped for Plans With Funding Ratios of Less Than 80 Percent



BOSTON PUBLIC LIBRARY
3 9999 05903 769 5

ISBN 0-16-046942-2