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Introductory Remarks

Good afternoon Chairman Grassley, Ranking Member Baucus, and members of the Committee. Thank you for inviting me to discuss the Administration's proposal to reform and strengthen the single-employer defined benefit pension system.

The Bush Administration believes that the pension promises companies have made to their workers and retirees must be kept. Single-employer, private sector defined benefit pension plans cover 16 percent of the nation's private workforce, or about 34 million Americans. The consequences of not honoring pension commitments are unacceptable—the retirement security of millions of current and future retirees is put at risk.

However, the current system does not ensure that pension plans are adequately funded. As a result, pension promises are too often broken.

Termination of plans without sufficient assets to pay promised benefits has a very real human cost. Many workers' and retirees' expectations are shattered, and, after a lifetime of work, they must change their retirement plans to reflect harsh, new realities. Underfunded plan terminations are also placing an increasing strain on the pension guaranty system.

Increased claims from terminations of significantly underfunded pension plans have resulted in a record deficit in the single-employer fund of the PBGC. For the fiscal year ending September 30, 2004, the PBGC reported a record deficit of $23.3 billion in that fund. The increasing PBGC deficit and high levels of plan underfunding are themselves a cause for concern. More importantly, they are symptomatic of serious structural problems in the private defined benefit system.

It is important to strengthen the financial health of the defined benefit plan system now. If significantly underfunded pension plans continue to terminate, not only will some workers lose benefits, but other plan sponsors, including those that are healthy and have funded their plans in a responsible manner, will be called on to pay far higher PBGC premiums. Underfunding in the pension system must be corrected now to protect worker benefits and to ensure taxpayers are not put at risk of being called on to pay for broken promises.

The Administration has developed a reform package to improve pension security for workers and retirees, stabilize the defined benefit system, and avoid a taxpayer bailout of PBGC. The President's proposal is based on three main elements:

First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises. The current system is ineffective and needlessly complex. The rules fail to ensure that many pension plans are and remain adequately funded.

Second, disclosure to workers, investors and regulators about pension plan status must be improved. Workers need to have good information about the funding status of their pension plans to make informed decisions about their retirement needs and financial futures. Too often in recent years, participants have mistakenly believed that their pension plans were well funded, only to receive a rude shock when the plan is terminated. Regulators and investors also require more timely and accurate information about the financial status of pension plans than is provided under current law.

Third, premium rates must be revised to more accurately reflect the risk of a plan defaulting on its promises and to help restore the PBGC to financial health. The current premium structure encourages irresponsible behavior by not reflecting a plan's true level of risk.

The proposal would strengthen the funding rules and defined benefit system, so that the nation's workers and retirees can be confident of the secure retirement they have worked for all their lives. I will now discuss the key provisions for each element of the President's proposal and the reasons these provisions are needed to protect the pensions of the 34 million Americans who are relying on the single-employer defined benefit pension promises made by their employers.

Reforming the Funding Rules

The funding rules are complicated and ineffective.

Current funding rules do not establish accurate funding targets and the lack of adequate consequences for underfunding a plan provides insufficient incentive for plans to become well funded. In addition, the funding rules fail to take into account the risk that a plan sponsor will fail.

Weaknesses in the current rules include, for example, multiple and inaccurate asset and liability measures and discount rates, smoothing mechanisms, credit balances that allow funding holidays to continue even as funding levels deteriorate, excessive discretion over actuarial assumptions, and varying and excessively lengthy amortization periods. As a result, companies can say they are fully funded when in fact they are substantially underfunded. Together these weaknesses allow companies to avoid making contributions when they are substantially underfunded. And in some circumstances, they actually prevent companies that want to increase funding of their pension plans from making additional contributions during good economic times.

These weaknesses contribute to the ability to manipulate funding targets which is of particular concern given the fact that they are set too low. There is no uniformity in liability measures under current law. In some cases, employers can stop making contributions when a plan is funded at 90 percent of "current liability." But current liability is not an accurate measure of pension funding requirements; even 100 percent of current liability is often far less than what will be owed if a plan is terminated. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants in the event of termination.

Why is current liability such a poor measure of true pension costs? One reason is that the interest rate used in determining current liability can be selected from an interest rate corridor that is based on an average of interest rates over the prior 48 months. As a result, during periods of rapidly changing interest rates, the current liability interest rate may bear little relationship to economic reality and misstate the risks to plan participants. Even if the current liability interest rate reflected current market conditions, it would produce an inaccurate measure of the plan's true liability because it is based on a long-term interest rate and fails to take into account the actual timing of when benefit payments will be due under the plan. That timing often is considerably sooner, especially for plans with a large number of older participants near retirement age.

Current liability also fails to account for the risk of plan termination. This is important because terminating plans incur additional costs not reflected in current liability. For example, when plans terminate, participants are more likely to draw benefits early and elect lump sums. Terminating plans must purchase insurance annuities at prices that reflect market interest rates and administrative expenses. These factors combine to escalate costs above those reflected in current liability, often by large amounts. While it is not necessary for all plans to fund to such a standard, in the case of a plan with a substantial risk of terminating, the pension funding target should take into account the additional costs of terminating the plan.

Another weakness in the funding rules is their reliance on the so-called "actuarial value" of plan assets. The actuarial value of plan assets may differ from the fair market value of plan assets. It may be determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years. The use of a smoothed actuarial value of assets distorts the funded status of the plan. Using fair market value for purposes of the funding rules would give a clearer and more accurate picture of a plan's ability to pay promised benefits.

As an example of how all of this can affect workers and retirees, the U.S. Airways pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $1.5 billion shortfall. After believing their pensions were substantially secure, U.S. Airways pilots were shocked to learn how much of their promised benefits would be lost. Bethlehem Steel's plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion.

The Bush Administration's Proposal

The current funding rules must be strengthened to ensure that accrued benefits are adequately funded. This is particularly important for those plans at the greatest risk of terminating. The Administration's plan will bring simplicity, accuracy, stability, and flexibility to the funding rules, encouraging employers to fully fund their plans and ensuring that benefit promises are kept.

Under the President's proposal, the multiple sets of funding rules applicable to single-employer defined benefit plans would be replaced with a single set of rules. The rules would provide for each plan a single funding target that is based on meaningful, accurate measures of its liabilities that reflect the financial health of the employer and use fair market values of assets. Funding shortfalls would be amortized and paid over 7 years. Plan sponsors would have the opportunity to make additional, tax-deductible contributions in good years, even when the plan's assets are substantially above its funding target. In addition to the changes to the funding rules, new limits would be placed on unfunded benefit promises, reporting and disclosure of funding information would be improved, and PBGC premiums would be reformed to more fully reflect the risks and costs to the insurance program.

Funding targets will depend on the plan sponsor's financial health.

Pension liability computations should reflect the true present value of accrued future benefits – this is a key component of accuracy. Workers and retirees are interested in the present value of liabilities so that they can determine whether their plans and promised benefits are adequately funded. Plan sponsors and investors are interested in the present value of liabilities in order to determine the demands pension liabilities will place on the company's cash flows.

The Administration's proposal provides a single conceptual measure of liabilities based on benefits earned to date. Assumptions are modified as needed to reflect the financial health of the plan sponsor and the risk of termination posed by the plan. A plan's funding target would be the a plan's ongoing, or alternatively, its at-risk liability, depending on the sponsor's financial health.

For a plan sponsor that is healthy, the funding target would be the plan's ongoing liability. The plan sponsor is considered financially healthy if any member of the plan sponsor's control group has senior unsecured debt rated as being investment grade (Baa or better). If a plan sponsor is financially weak, the funding target generally would be the plan's at-risk liability. A plan sponsor is considered financially weak if its senior unsecured debt is rated as below investment grade by every rating agency that rates the sponsor. A plan's funding target would phase up from ongoing to at-risk over a five-year period. Conversely, if a plan's credit rating is upgraded to investment grade, its funding target would immediately drop to ongoing liability.

Credit ratings are used to measure financial health because empirical evidence shows that a company's time spent in below investment grade status is a strong indicator of the likelihood of plan termination. It is also critical that a market-based test be used to establish financial health.

A plan's ongoing liability is equal to the present value of all benefits that the plan is expected to pay in the future, based on benefits earned through the beginning of the plan year. Workers are assumed to retire and to choose lump sums as others have in the past. A plan's at-risk liability is based on the same benefits, but assumes that employees will take lump sums and retire as soon as they can, and includes an additional amount reflective of the transaction cost of winding up a plan. These assumptions are designed to reflect behavior that typically occurs prior to plan termination when the financial health of the employer deteriorates.

The applicable funding target is calculated by discounting benefit liabilities based on a yield curve of long-term corporate bonds. The discount rate would reflect the duration of the liabilities. A plan's actuary would project the plan's cash flow in each future year and discount payments using the appropriate interest rate for the payment. In general, with a typical yield curve, plans with older workforces where payments are due sooner will discount a greater proportion of their liabilities with the lower interest rates from the short-end of the yield curve than plans with younger workforces where larger cash payments are delayed into the future. The corporate bond yield curve would be published by the Secretary of Treasury and would be based on the interest rates, averaged over 90 business days, for high quality corporate bonds rated AA, with varying maturities.

The use of a single conceptual measure of liabilities will simplify the funding rules. It will tell plan sponsors, investors, regulators, and most importantly, workers and retirees, whether a plan is adequately funded.

Funding shortfalls should be made up over a reasonable period.

Another problem with the current funding rules is that underfunded plans are permitted to make up their shortfalls over too long a period of time. In addition, underfunded plans are permitted funding holidays. These rules put workers at risk of having their plans terminate without adequate funding.

Under current law, if the unfunded accrued liability is attributable to a plan amendment, the amortization period for making up the shortfall is 30 years. Experience shows this is too long. There is too much risk that the plan will be terminated before 30 years has passed. Furthermore, collectively bargained plans often have a series of benefit increases every few years, which has the effect of increasing all of the liabilities accrued prior to the benefit increase as well as increasing future liabilities. As a result, these plans are perennially underfunded.

The credit balance rules for plan funding under current law also contribute to plan underfunding. The credit balance rules allow an employer to apply their contributions in excess of minimum requirements from an earlier year as an offset to the minimum funding requirement for a subsequent year without restrictions. This loophole allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market – and, more importantly, regardless of the current funded status of the plan. Credit balance rules harm the retirement security of workers and retirees. In the Bethlehem Steel and the U.S. Airways pilots' plan termination cases, for example, no contributions were made (or required to be made, as a result of credit balances) to either plan during the three or four years leading up to plan termination.

Under the Administration's proposal, plans would annually contribute enough to address their funding shortfall over a reasonable period of time, without funding holidays, until the shortfall is eliminated. Plan funding shortfalls would be amortized over a 7-year period. The current law provision allowing an extension of amortization periods would no longer be available.

Opportunity to increase funding in good years.

We also must address the overly prescriptive funding rules for well-funded plans that discourage companies from building up a cushion to minimize contributions in lean years. To keep healthy companies in the defined benefit system, we need to give them better incentives.

The current funding rules can place a pension plan sponsor in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. This problem is caused by the interaction of the minimum funding requirements and the rules governing maximum deductible contributions. The rules restrict employers' ability to build up a cushion that could minimize the risk that contributions will have to be severely increased in poor economic times. This volatility in required contributions makes it difficult for plan sponsors to predict their funding obligations, and makes it difficult to prevent large required contributions during economic downturns when the company is least able to pay.

The Administration's proposal would permit plan sponsors to make additional deductible contributions up to a new higher maximum deductible amount. This would permit companies to increase funding during good economic times. Funding would be permitted on a tax-deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year, the applicable normal cost and a specified cushion. The cushion amount would enable plan sponsors to protect against funding volatility, and would be equal to 30 percent of the plan's funding target plus an amount to pre-fund projected salary increases (or projected benefit increases in a flat dollar plan). Plans would always be permitted to fund up to their at-risk liability target.

This cushion will help provide workers and retirees greater retirement security by increasing the assets available to finance retirement benefits.

Limitations on plans funded below target levels.

The current rules encourage some plans to be chronically underfunded, in part, because they shift potential losses to third parties. This is what economists refer to as a "moral hazard." Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in some situations, even make new benefit promises, while pushing the cost of paying for those benefits off into the future. For this reason, some companies have an incentive to provide generous pension benefits that they cannot currently finance, rather than increase wages. The company, its workers and any union officials representing them know that at least some of the additional benefits will be paid, if not by their own plan, then by other plan sponsors in the form of PBGC guarantees. Under our proposed funding rules, financially strong companies, in contrast, have little incentive to make unrealistic benefit promises because they know that they fund them in a reasonably timely manner.

If a company's plan is poorly funded, the company should be precluded from adopting further benefit increases unless it fully funds them, especially if it is in a weak financial position. If a plan is severely underfunded, retiring employees should not be able to elect lump sums and similar accelerated benefits. The payment of those benefits allows those participants to receive the full value of their benefits while depleting the plan assets for the remaining participants. A similar concern applies when a severely underfunded plan purchases annuities.

The Administration believes that we must ensure that companies, especially those in difficult financial straits, make only benefit promises they can afford, and take steps to fulfill their promises already made by appropriately funding their pension plans. In order to accomplish this goal, the proposal would place additional meaningful limitations on plans that are funded substantially below target levels.

First, the rules would limit benefit increases for certain underfunded plans. For a plan where the market value of the plan's assets is less than or equal to 80 percent of the funding target, no amendment increasing benefits would be permitted. If the market value of the plan's assets is above 80 percent of the funding target, but was less than 100 percent for the prior plan year, then no benefit increase amendment that would cause the market value of the plan's assets to be less than 80 percent of the funding target would be permitted. In either case, the sponsor could avoid the application of these limits by choosing to contribute the minimum required contribution and the increase in the funding target attributable to an amendment increasing benefits.

Second, the rules would limit lump sum distributions or other accelerated benefit distributions for certain underfunded plans. Limits would apply if either the market value of a plan's assets is less than or equal to 60 percent of the funding target or the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 80 percent of the funding target.

Third, the rules would limit accruals for plans with severe funding shortfalls or sponsors in bankruptcy with assets less than the funding target. A plan is considered severely underfunded if the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 60 percent of the funding target. These plans pose great risk of plan termination and would effectively be required to be frozen.

Lastly, the rules would address an abuse recently seen in the airline industry – where executives of companies in financial difficulty have their nonqualified deferred compensation arrangements funded and made more secure, without addressing the risk to the retirement income of rank and file employees caused by severely underfunded pension plans. The rules would prohibit funding such executive compensation arrangements if a financially weak plan sponsor has a severely underfunded plan. Also, the rules would prohibit funding executive compensation arrangements less than 6 months before or 6 months after the termination of a plan where the plan assets are not sufficient to provide all benefits due under the plan. A plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition to recover the amount that was funded.

Plans that become subject to any of these benefit limitations would be required under ERISA to furnish a related notice to affected workers and retirees. In addition to letting workers know that limits have kicked in, this notice will alert workers when funding levels deteriorate and benefits already earned are in jeopardy.

Improving Disclosure to Workers, Investors, and Regulators

The financial health of defined benefit plans must be transparent and fully disclosed to the workers and their families who rely on promised benefits for a secure and dignified retirement. Investors and other stakeholders also need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

For example, the principal Federal source of information about private sector defined benefit plans is the Form 5500. Schedule B, the actuarial statement filed with the Form 5500, reports information on the plan's assets, liabilities and compliance with funding requirements. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, regulatory agencies are not notified of the plan's funded status for almost two years after the actual valuation date. If the market value of a plan's assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

The PBGC does receive more timely information regarding a limited number of underfunded plans that pose the greatest threat to the system under Section 4010 of ERISA. Section 4010 data provides identification, financial, and actuarial information about the plan. The financial information must include the company's audited financial statement. Sponsors also are required to provide actuarial information that includes the market value of their pension plan's assets, the value of the benefit liabilities on a termination basis, and a summary of the plan provisions for eligibility and benefits.

However, current law prohibits disclosure, so this information may not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan is vitally important to participants and investors. Making information regarding the financial condition of the pension plan publicly available would benefit investors and other stakeholders and is consistent with federal securities laws that Congress has strengthened to require the disclosure of information material to the financial condition of a publicly-traded company.

The most fundamental disclosure requirement of a pension's funding status to workers under current law is the summary annual report (SAR). The SAR discloses certain basic financial information from the Form 5500 including the pension plan's net asset value, expenses, income, contributions, and gains or losses. Pension plans are required to furnish a SAR to all covered workers and retirees within two months following the filing deadline of the Form 5500.

Information on a plan's funding target and a comparison of that liability to the market value of assets would provide more accurate disclosure of a plan's funded status. Providing information on a more timely basis would further improve the usefulness of this information for workers and retirees.

The Bush Administration's Proposal

The Administration's proposal would allow information filed with the PBGC to be disclosable to the public and would provide for more timely and accurate disclosure of information to workers and retirees.

Provide broader dissemination of plan information.

Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, except for the information subject to Freedom of Information Act protections for corporate financial information, which includes confidential "trade secrets and commercial or financial information."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Provide more meaningful and timely information.

The President's proposal would change the information required to be disclosed on the Form 5500 and SAR. Plans would be required to disclose the plan's ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year, or February 15 for a calendar year plan. If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Reforming Premiums to Better Reflect Plan Risk and Restoring the PBGC to Financial Health

There are two fundamental problems with PBGC premiums. First, the premium structure does not meet basic insurance principles, including those that govern private-sector insurance plans. Second, the premiums do not raise sufficient revenue to meet expected claims. The single-employer program lacks risk-based underwriting standards. Plan sponsors face limited accountability regardless of the risk they impose on the system. As a result, there has been a tremendous amount of cost-shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

This excessive subsidization extends across industry sectors – to date, the steel and airline industries have accounted for more than 70 percent of PBGC's claims by dollar amount while covering less than 5 percent of the insured base.

The PBGC also needs better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs. Recent events have demonstrated that the agency's ability to protect the interests of beneficiaries and premium payers is extremely limited. This is especially true when a plan sponsor enters bankruptcy or provides plant shutdown benefits -- benefits triggered by a plant closing or other condition that are generally not funded until the event occurs. Currently, the agency has few tools at its disposal other than to move to terminate plans in order to protect the program against further losses.

The Bush Administration's Proposal

The Administration's proposal would reform the PBGC's premium structure. The flat per-participant premium will be immediately adjusted to $30 initially to reflect the growth in worker wages since 1991, when the current $19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages during this period, even as the premium was frozen. Going forward, the flat rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a risk-based premium will be charged based on the gap between a plan's funding target and its assets. Because the funding target takes account of the sponsor's financial condition, tying the risk based premium to the funding shortfall effectively adjusts the premium for both the degree of underfunding and the risk of termination. All underfunded plans would pay the risk based premium. The PBGC Board – which consists of the Secretaries of Labor, Treasury and Commerce – would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC's financial condition. Charging underfunded plans more gives employers an additional incentive to fully fund their pension promises.

As part of improving PBGC's financial condition, additional reforms are needed. Plan sponsor bankruptcies and plant shutdown benefits increase the probability of plan terminations and impose unreasonable costs on the PBGC. The proposal would freeze the PBGC guarantee limit when a company enters bankruptcy and allow the perfection of liens during bankruptcy by the PBGC for missed required pension contributions. The proposal also would prospectively eliminate the guarantee of certain unfunded contingent liability benefits, such as shutdown benefits, and prohibit such benefits under pension plans.

Conclusion

The Bush Administration is committed to working with Congress to ensure that the defined benefit pension reforms included with the President's Budget – strengthening the funding rules, improving disclosure, and reforming premiums – are enacted into law.

As I noted earlier, the primary goals of the Administration's proposal are to improve pension security for workers and retirees, to stabilize the defined benefit pension system, and to avoid a taxpayer bailout of the PBGC. This can be achieved by strengthening the financial integrity of the single-employer defined benefit system and making sure that pension promises made are promises kept. We look forward to working with Members of this Committee to achieve greater retirement security for the millions of Americans who depend on defined benefit plans.